S. HRG. 98-790

TAX TREATMENT OF LIFE INSURANCE PRODUCTS AND POLICYHOLDERS

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

S. 1992

JANUARY 31, 1984

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TAX TREATMENT OF LIFE INSURANCE PRODUCTS AND POLICYHOLDERS

TUESDAY, JANUARY 31, 1984

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 9:32 a.m., in room SD-215, Dirksen Senate Office Building, Hon. John Chafee presiding.

Present: Senators Chafee, Packwood, Bentsen, Symms, Moynihan, Boren, and Baucus.

[The press release announcing the hearing, the prepared statement of Senator Grassley and the report from the Joint Committee on Taxation follows:]

[Press Release]

SENATE FINANCE COMMITTEE SETS HEARINGS ON TAX TREATMENT OF LIFE INSURANCE PRODUCTS AND POLICYHOLDERS

The Honorable Robert J. Dole (R. Kansas), Chairman of the Senate Finance Committee, announced today that the Committee will hold a hearing on provisions of S. 1992, the Life Insurance Tax Act of 1983, that affect directly the tax treatment of life insurance products.

The hearing will begin at 9:30 a.m. on January in Room SD-215 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Dole noted that although there appeared to be general agreement regarding the basic structural method proposed in S. 1992 for taxing the life insurance companies themselves, the bill's proposals for taxing life insurance products and policyholders have caused some controversy. "I believe a hearing on the insurance products would be useful, especially since much of the attention of both the House Ways and Means Committee and of the Senate has been focused on company taxation," Dole stated. "I hope that this hearing will provide an opportunity to examine the uses and the potential abuses of life insurance products, and to consider the tax treatment that best serves the legitimate insurance needs of policyholders."

Specifically, Senator Dole noted that he anticipated that the hearing would focus on the proper tax treatment for policyholders who receive distributions from annuity contracts, who are covered by employer-provided group life insurance, or who incur loans based on the underlying cash value of their insurance policies, as well as on the appropriate tax treatment of variable annuity contracts and variable life insurance contracts. In addition, the Senator stated that he hoped that the hearing would give the opportunity to the Committee to receive testimony on whether any changes would be appropriate with respect to the definition of a life insurance contract that is used in the bill.

OPENING STATEMENT OF SENATOR CHUCK GRASSLEY

Mr. CHAIRMAN. I would like to thank you for gathering this distinguished panel of witnesses to comment on S. 1922, the Life Insurance Tax Act of 1983. As a co-sponsor of this legislation, I would particularly like to thank the two authors of this bill, Congressmen Stark and Moore, for their fine work in drafting a solution to this difficult problem. They have done an excellent job balancing the interests of the stock and mutual life insurance companies and they deserve our praise and gratitude.

I strongly support the Stark-Moore compromise, and I would encourage my colleagues to enact it quickly. Life insurance is a major industry for my home state of Iowa. Iowa has large mutuals, medium to large stocks and many small mutual and stock life insurance companies. The Stark-Moore compromise addresses the concerns of this broad spectrum of companies. All of these companies crave tax certainty. They are anxious to have Congress act quickly to enact a new system of taxation for them. While my constituent companies may have minor disagreements with some portions of this comprehensive legislation, they are extremely reticent to support any changes which might jeopardize the passage of this legislation.

This is a view I share. My paramount concern is the enactment of the Stark-Moore compromise. If an amendment threatens that compromise, I would have great difficulty supporting it. The goal of a certain tax structure for the life insurance industry of my state overrides any minor controversial technical modification to this legislation.

During the TEFRA debate, I stated that I supported the stopgap proposal on the basis that it generated the revenue the industry promised. While I understand the difficult economic times faced by all American corporations, I am interested in learning the explanation of why the projections vary from experience. The appropriate level of tax within the Stark-Moore structure is an issue of great interest to me. I look forward to the comments of the witnesses on this critical issue.

Finally, I would like to compliment the life insurance industry for their hard work in achieving a compromise. It is rare that an industry with conflicting interests can devise a way to tax itself. Their good faith efforts in achieving a consensus with members of the House and Senate will long be remembered by both tax writing committees.

Thank you, Mr. Chairman.

DESCRIPTION OF PROVISIONS OF S. 1992 RELATING TO LIFE INSURANCE PRODUCTS AND POLICYHOLDERS

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON JANUARY 31, 1984

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing for January 31, 1984, on the provisions of S. 1992,[1] the Life Insurance Tax Act of 1983 (introduced by Senators Bentsen, Chafee, Moynihan, Danforth, Boren, Grassley, Wallop, Durenberger, Bradley, and Mitchell), relating to the tax treatment of individuals. These provisions relate to (1) the definition of life insurance, (2) the treatment of variable annuity or life insurance contracts, (3) the treatment of distributions from annuities, (4) the deductibility of interest on policyholder loans, (5) the taxation of group-term life insurance benefits, and (6) the allowance of nondeductible contributions to individual retirement plans.

The first part of the pamphlet is a summary. This is followed in the second part by a more detailed description of present law and the provisions of S. 1992 relating to the treatment of life insurance products and policyholders and to the allowance of nondeductible contributions to individual retirement plans.

I. SUMMARY

S. 1992 would affect the tax treatment of individuals in six specific areas.

First, the bill would provide a comprehensive definition of life insurance for tax purposes. Under present law, a policyholder is not taxed on the investment earnings of a life insurance contract unless the policy is surrendered or matures prior to the death of the insured. The bill would provide for current taxation of the investment portion of certain investment-oriented contracts currently being sold as life insurance. Generally, these contracts would be those that allow for a substantial investment of cash as premiums or permit an accumulation of income as a cash surrender value that is excessive relative to the insurance risk under the contract.

Second, present law provides for taxation at the company level on capital gains realized on assets held for variable annuity contracts. In contrast, in the case of a variable life insurance contract, capital gains are taxed only to the contractholder, and then only if the contract is surrendered or matures prior to the death of the insured. Under the bill, the rules for variable annuities would be extended for variable life insurance contracts.

Third, present law imposes a 5-percent penalty on premature distributions from deferred annuity contracts. Generally, a distribution is premature if made before the annuitant attains age 59½; however, an exception applies to distributions of income allocable to investments made at least 10 years before the distribution. The bill would delete this exception. Also, under the bill, if the holder of a deferred annuity dies before the annuity starting date, the undistributed income would be taxed to the decedent-annuity holder in the taxable year ending with the annuity holder's death.

Fourth, present law allows policyholders to deduct interest paid on loans secured by the cash surrender value of life insurance except in certain specific abuse cases. Under these rules, it is possible to purchase life insurance protection in such a way that the combination of tax-free build-up of the cash surrender value and deduction of interest on the borrowing of that cash surrender value produces a positive after-tax return to the policyholder. The bill would limit the amount of interest that could be deducted with respect to loans secured by the cash surrender value of life insurance. This limitation would be equal to the product of the tax deficiency rate times $250,000 ($500,000 in the case of life insurance held in connection with a trade or business).

Fifth, under present law, the value of group-term life insurance protection provided to employees is excluded from the employees' income subject to a $50,000 limitation. Also, the exclusion is not available with respect to discriminatory plans. The bill would apply the $50,000 limitation and the nondiscrimination rules to group-term life insurance coverage provided to retired employees.

Sixth, under present law, contributions to individual retirement accounts are limited to those that are deductible for income tax purposes. The bill would permit nondeductible contributions of up to $1,750 per year.

II. DESCRIPTION OF PROVISIONS OF S. 1992

A. Definition of Life Insurance Contract

Present Law

Generally, there is no comprehensive definition of a life insurance contract that applies for all tax purposes. A life insurance contract is defined for purposes of section 1035 (relating to tax-free exchanges) as a contract with a life insurance company which depends in part on the life expectancy of the insured and which is not ordinarily payable in full during the life of the insured.

Income earned on the cash surrender value of a life insurance contract is not taxed currently to the policyholder, but is taxed upon termination of the contract prior to death to the extent that the cash surrender value exceeds the policyholder's investment in the contract. The investment in the contract at any date is the aggregate amount of premiums and other consideration paid for the contract to date, less any amount returned or received under the contract that was excluded from gross income. No adjustment is made to the investment in the contract to account for the cost of the current life insurance protection received under the contract to such date. Gross income does not include amounts received by a beneficiary under a life insurance contract, if the amounts are paid because of the death of the insured.

This special tax treatment has been accorded to life insurance products because, arguably, an adequately insured work force contributes to the general economic welfare. However, in recent years, insurers have seemed to emphasize the tax-advantaged treatment in designing products. This raises the question of whether some products are being sold (and bought) primarily as investment vehicles, with the provision of a death benefit being the secondary consideration.

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress enacted temporary guidelines for determining whether flexible premium life insurance contracts (e.g., universal life or adjustable life contracts) qualify as life insurance contracts for purposes of the exclusion of death benefits from income. The guidelines apply to contracts issued in 1982 and 1983. They were adopted to ensure that products similar to level-premium whole life insurance contracts or other traditional products would receive comparable tax treatment. At the same time, Congress sought to deny traditional tax treatment to other investment-oriented products which provide for the accumulation of large amounts of cash surrender value and a relatively small amount of pure insurance protection.

Violation of the guidelines at any time during the contract will cause the contract to be treated as providing a combination of term life insurance and an annuity or a deposit fund (depending on the terms of the contract). In the event of the death of the insured, only the term life insurance component is excluded from gross income.

1982 and 1983 temporary guidelines

Under the temporary guidelines, death proceeds from flexible premium lie insurance contracts are treated as life insurance if either of two tests is met.

Alternative 1

Under the first of the two tests, a contract qualifies if:

(a) the sum of the premiums paid for the benefits at any time does not exceed the greater of the net single premium (based on a 6-percent interest rate) or the sum of the net level premiums (based on a 4-percent interest rate), assuming the policy matures no earlier than in 20 years or at age 95 (if earlier); and

(b) the death benefit is at least 140 percent of cash value at age 40, phasing down one percentage point each year thereafter to 105 percent at age 76 or older.

Alternative 2

Under the second of the two tests, a contract qualifies if the cash surrender value does not exceed the net single premium (based on a 4-percent interest rate) for the amount payable at death, assuming the policy matures no earlier than in 20 years or at age 95 (if earlier).

Explanation of Provision

The bill would provide a definition of a life insurance contract for purposes of the Internal Revenue Code. Rules that are similar to those contained in the temporary provisions of TEFRA would be extended to all life insurance contracts. Like the temporary provisions, the proposed definition would restrict the use of new investment-oriented products as life insurance. In addition, some traditional products currently sold as life insurance, but which allow the accumulation of a substantial amount of cash value with a comparatively small amount of pure insurance protection, would no longer be treated as life insurance.

Definition of life insurance

A life insurance contract would be defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternative tests: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium limitation and a cash value corridor. In the case of variable life insurance contracts, the determination of whether the contract meets either of these tests would be made whenever the amount of the death benefits under the contract change, but not less frequently than once during each 12-month period.

Cash value accumulation test

The first alternative test under which a contract could qualify as a life insurance contract would be the cash value accumulation test. This test would allow traditional whole life policies with cash values that accumulate based on interest rates of 4 percent or greater to continue to qualify as life insurance contracts. Certain contracts traditionally sold by life insurance companies, such as endowment contracts maturing earlier than age 95, would not continue to be classified as life insurance contracts because of their innate investment orientation (i.e., the accumulation of large amounts of cash surrender value relative to the amount of pure insurance protection).

Under this test, the cash surrender value of the contract could not, by the terms of the contract, at any time exceed the net single premium which would have to be paid at that time in order to fund the future benefits under the contract, assuming the contract matures no earlier than age 95 for the insured. The term future benefits under the bill means death benefits and endowment benefits. Generally, the death benefit is the amount that is payable in the event of the death of the insured. Cash surrender value is defined in the bill as the cash value of any contract (i.e., any amount to which the policyholder would be entitled upon surrender and against which the policyholder generally could borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend.

The reasonable or unreasonable nature of a termination dividend might be determined by reference to the historical practice of the industry. For example, New York State prescribes a maximum termination dividend of $35 per $1,000 of face amount of the policy. Just as termination dividends are not reflected in the cash surrender value, any policyholder dividends left on deposit with the company to accumulate interest would not be part of the cash surrender value of a contract; interest income on such dividend accumulations is currently taxable to the policyholder because the amounts are not held pursuant to an insurance or annuity contract. Likewise, amounts that are returned to a policyholder of a credit life insurance policy because the policy has been terminated upon full payment of the debt would not be considered part of any cash surrender value because, generally, such amount is not subject to borrowing under the policy.

Whether a contract is a life insurance contract under this test would be determined on the basis of the terms of the contract. In making the determination that a life insurance contract meets the cash value accumulation test, the net single premium would be computed using a rate of interest that is the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. Because the definitional test refers to the cash surrender value, the rate guaranteed on the issuance of the contract would be that reflected in the contract's nonforfeiture values. With respect to variable contracts that may not have a guaranteed rate, then the 4-percent rate would apply. The mortality charges taken into account in computing the net single premium would be those specified in the contract or, if none are specified in the contract, the mortality charges used in determining the statutory reserves for the contract.

The amount of any qualified additional benefits would not be taken into account in determining the net single premium. However, the charge stated in the contract for the qualified additional benefit would be treated as a future benefit, thereby increasing the allowable cash value accumulation by the discounted value of such charge. For life insurance contracts, qualified additional benefits would be guaranteed insurability, accidental death or disability, family term coverage, disability waiver, and any other benefits prescribed under regulations. In the case of any other additional benefit which is not a qualified additional benefit and which is not prefunded, neither the benefit nor the charge for such benefit would be taken into account. For example, if a contract provides for annual business term insurance as an additional benefit, neither the term insurance nor the charge for the insurance would be considered a future benefit.

Guideline premium and cash value corridor test requirements

The second test under which a contract could qualify as a life insurance contract would impose two requirements: the guideline premium limitation and the cash value corridor. The guideline premium portion of the test would distinguish between contracts under which the policyholder makes traditional levels of investment through premium payments and those which involve greater investments by the policyholder. The second requirement, the cash value corridor, would disqualify contracts that build up excessive amounts of cash value (i.e., premiums, plus income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements would tend to limit the benefits of life insurance treatment to contracts that have premiums, investment levels, and investment returns that reflect an insurance as well as an investment orientation. At the same time, these requirements still would allow investment returns, and tax deferral thereon, that exceed the amount necessary to fund the specified future benefits of the contract.

The specifics of these requirements are described below.

Guideline premium requirements

A life insurance contract would meet the guideline premium limitation of the second test if the the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date. The guideline single premium for any contract would be the premium at the date of issue required to fund the future benefits under the contract. The computation of the guideline single premium must take into account (1) the mortality charges specified in the contract, or used in determining the statutory reserves for the contract if none is specified in the contract, (2) any other charges specified in the contract (either for expenses or for supplemental benefits), and (3) interest at the greater of a 6-percent annual effective rate or the minimum rate or rates guaranteed on the issuance of the contract. The guideline level premium would be the level annual amount, payable over a period that does not end before the insured attains age 95, which is necessary to fund future benefits under the contract. The computation is made on the same basis as that for the guideline single premium, except that the statutory interest rate is 4 percent instead of 6 percent.

A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation would not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year, but only if the contract would terminate without cash value but for such payment. Also, if it is established to the satisfaction of the Secretary that the requirement was not met due to reasonable error and reasonable steps are being taken to remedy the error, the Secretary could waive the first requirement. Premium amounts returned to a policyholder, with interest, within 60 days after the end of a contract year in order to comply with the guideline premium requirements would be treated as a reduction of the premiums paid during the year. The interest paid on such return premiums would be includible in gross income. This "hold harmless" provision in the event of a timely correction is comparable to similar provisions elsewhere in the Code.

Cash value corridor

A life insurance contract will meet the cash value corridor if the death benefit under the contract at any time is equal to at least the applicable percentage of the cash surrender value. Applicable percentages are set forth in a statutory table. Under the table, an insured person who is 55 years of age at the beginning of a contract year and has a life insurance contract with $10,000 in cash surrender value, must have a death benefit at that time of at least $15,000 (150 percent of $10,000).

As the following table shows, the applicable percentage to determine the minimum death benefit would start at 250 percent of the cash surrender value for an insured person up to 40 years of age, and the percentage would decrease to 100 percent when the insured person reaches age 95. Starting at age 40, there are 9 age brackets with 5-year intervals (except for one 15-year interval) to which a specific applicable percentage range has been assigned. The applicable percentage would decrease by the same amount for each year in that age bracket. For example, for the 55 to 60 age bracket, the applicable percentage falls from 150 to 130 percent, or 4 percentage points for each annual increase in age. At 57, the applicable percentage would be 142.

The statutory table of applicable percentages follows.

In the case of an insured with an attained age as of the beginning of the contract year of:		*The applicable percentage shall decrease by a ratable portion for each full year:*	
More than:	But not more than:	From:	To:
0	40	250	250

40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

The applicable percentages under the temporary provisions of present law phase down (ratably and annually) from 140 percent for ages up to 40 years to 105 percent at age 76 and older. In comparison, the proposed percentages generally would restrict the accumulation of cash value more than the percentages in the temporary provisions, but still would allow more generous cash value accumulation than would occur under a traditional policy. Because the proposed phase-down occurs at different rates over the various age intervals, the proposed percentages would tend to provide for accumulation at a greater rate for ages 55 and older than for earlier ages.

Computation of benefits

The bill would provide three general computational rules. These rules are directed, generally, at preventing insurance companies from avoiding the definitional limitations by creative product design. First, in computing the benefits under any contract, the death benefit would be deemed not to increase at any time during the life of the contract (qualified additional benefits would be treated in the same way). Thus, a contract could not assume a death benefit that is level, then decreases, only to increase again, in order to allow earlier funding of an increased future benefit, and still satisfy the premium guideline limitation. Second, the maturity date would be deemed to be no earlier than the day on which the insured attains age 95. This rule generally would prevent contracts endowing before age 95 from qualifying as life insurance. Third, the amount of any endowment benefit, or the sum of any endowment benefits, would be deemed not to exceed the least amount payable as a death benefit at any future time under the contract.

Notwithstanding the first computational rule, an increase in the death benefit that is provided in the contract, and which is limited to the amount necessary to prevent a decrease in the excess of the death benefit over the cash surrender value, could be taken into account for purposes of meeting the two definitional tests provided under the bill. Specifically, for a contract qualifying under the guideline premium requirement, this type of increasing death benefit could be taken into account in computing the guideline level premium. Thus, in such a case, the premium limitation would be the greater of the guideline single premium computed by assuming a nonincreasing death benefit or the sum of the guideline level premiums computed by assuming an increasing death benefit. In the case of a contract qualifying under the cash value accumulation test, the above described increasing death benefit could be taken into account if the cash surrender value of the contract could exceed at any time the net level reserve. For this purpose, the net level reserve would be determined as though level annual premiums were paid for the contract until the insured attains age 95. These modifications to the computational rules would allow the sale of contracts with limited increases in death benefits, for example, where the death benefit is defined as the cash surrender value plus a fixed amount of pure life insurance protection.

Adjustments

Changes in the terms of a contract might occur at the behest of the company or the policyholder, or by the passage of time. In the event of such changes, the limitations under the alternative tests would be recomputed, treating the date of change as a new date of issue. Thus, if the future benefits were increased because of a scheduled change in death benefit (other that an increase resulting from the crediting of excess interest) or the purchase of paid-up additions, such changes would require an adjustment and recomputation of the definitional limitations. Under the bill, the Secretary of the Treasury would have authority to prescribe regulations governing how such recomputations should be made. Further, there is a special provision that any change in the terms of a contract that would reduce the future benefits under the contract shall be treated as an exchange of contracts (under sec. 1035), and so may give rise to a distribution taxable to the policyholder.

Contracts not meeting the life insurance definition

If a life insurance contract fails to meet either of the alternative tests, the income on the contract for any taxable year of the policyholder would be treated as ordinary income received or accrued by the policyholder during that year. For this purpose, the income on the contract for any taxable year would be the amount by which the sum of the increase in the net surrender value of the contract and the cost of life insurance protection provided exceeds the amount of the premiums paid reduced by the amount of any policyholder dividends distributed during the year. Because the income on the contract would be treated as received by the policyholder, presumably the income would be a distribution subject to the recordkeeping, reporting, and withholding rules under present law relating to commercial annuities (including life insurance).

Under the bill, the income on the disqualified contract for all prior taxable years would be treated as received or accrued during the taxable year in which the life insurance contract ceases to meet the definition of a life insurance contract. The cost of life insurance protection provided under any contract would be the lesser of the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums computed using 5-year age brackets, as prescribed by the Secretary by regulations, or the mortality charge stated in the contract.

Death benefits paid under a disqualified contract would not be entitled to the same exclusion from income as benefits paid under a qualifying contract. Only the excess of the amount of death benefit paid over the net surrender value of the contract would be treated as paid under a life insurance contract and excluded from the beneficiary's income.

If a life insurance contract fails to meet the tests in the definition, it would, nonetheless, be treated as an insurance contract for company tax purposes. This ensures that the premiums and income credited to failing policies would continue to be taken into account by the insurance company in computing its taxable income.

Effective Date

General effective date

Generally, the new definition of life insurance would apply to contracts issued after December 31, 1983. Contracts issued in exchange for existing contracts after December 31, 1983, would be considered new contracts issued after that date.[1]

Transition rules

Contracts issued during 1984.—Any insurance contract that is issued during 1984 would be treated as meeting the definitional requirements of a life insurance contract if the contract meets: (1) the requirements of the temporary provisions enacted in TEFRA, or (2) for a contract that is not a flexible premium life insurance contract (defined under Sec. 101(f)), the requirements set forth in the bill by substituting 3 percent for 4 percent as the minimum interest rate to be used in applying the cash value accumulation test.

Contracts issued pursuant to existing plans of insurance.—Under another transition rule, certain "qualified contracts" under existing plans of insurance would qualify as life insurance contracts under the cash value accumulation test if the contracts would meet the test using 3 percent, instead of 4 percent, as the minimum interest rate. A "qualified contract" would be any contract that requires at least 20 level annual premium payments and is issued pursuant to any plan of insurance which has been filed by the issuing company in one or more States before September 28, 1983. Presumably, the 20-pay requirement would not be violated by a plan of insurance that provides for the purchase of insurance by means of paid-up additions, if the additional amounts are modest and reasonable compared with the basic benefit under the contract.

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[1] It is unclear whether a reduction in death benefits (which would be a change in future benefits requiring an adjustment and recomputation of the definitional limits, and which would be treated as an exchange of contracts under the adjustment provisions) would be considered an exchange under this provision also.

B. Variable Annuities and Variable Life Insurance

Present Law

In general, either a variable annuity[2] or a variable life insurance contract is a contract under which any amounts or premiums received are invested in a separate asset account of the insurance company, and the amounts paid in or paid out reflect the investment return and the market value of such separate account. Under a variable annuity, either the cash surrender value before the annuity starting date or annuity payments made after the annuity starting date (or both) would reflect the investment activity of the separate account; under a variable life insurance contract, the cash surrender value and the amount of death benefit would fluctuate with the investment activity of the separate account. Because the contract benefits can fluctuate and a particular investment return is not guaranteed by the insurance company, the contractholder can be said to bear the investment risk under the contract.[3]

In addition to the definitional concern that the tax benefits of life insurance products should not be given to contracts that are too investment oriented, the sale of variable contracts (both annuity and life insurance) raises the additional issue of whether competitive equity investment vehicles enjoy, under present law, the same status for tax purposes. For example, one might look through the purchase of a variable insurance contract, viewing it rather as the purchase of a share in a mutual fund.[4] Despite the similarity of their investment returns, there can be substantive differences between the individual tax treatment of a variable contract sold by an insurance company and that of a share in a mutual fund. An owner of a mutual fund share is taxed currently on the ordinary and capital gain income of the mutual fund. Likewise, the transfer from shares in one fund for shares in another can give rise to capital gain income. In contrast, under a variable contract based by a separate account issued by an insurance company, the tax on the income of the fund that is credited to the policyholder is deferred. Further, under section 1035, gain on an exchange of life insurance contacts or annuity contracts[5] is generally not recognized. On the other hand, gain on the sale by a mutual fund of a capital asset retains its character in the hands of an individual owner of a mutual fund share. In contrast, gain on the sale by an insurance company of an asset held in a segregated asset account is taxed to a holder of a variable contract on distribution at ordinary income rates.

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[2] The term variable annuity will be used generally to refer to a contract which reflects the investment activity of a company and also a contract that reflects the investment return and market value of a segregated asset account within a company, although the latter may be referred to more specifically as "a contract with reserves based on a segregated asset account." See sec. 801(g).

[3] Generally, a certain minimum death benefit will be guaranteed by the insurance company. Thus, to the extent there is a minimum death benefit, the company bears the investment risk.

[4] Both variable annuities and variable life insurance are securities subject to the Securities Act of 1933. For a specific discussion concerning this classification, for variable annuities, *see* SEC V., *Variable Life insurance Company of America*, 359 U.S. 65 (1959).

[5] Code sec. 1035 provides that no gain or loss is recognized on the exchange of (1) a life insurance contract for another life insurance contract, an endowment contract or an annuity contract; (2) an endowment contract for another comparable contract or an annuity contract; or (3) an annuity contract for an annuity contract.

Generally, income on an annuity contract is taxed only once, at the policyholder level when the income is distributed. This is accomplished by means of a deduction at the company level for amounts credited to policyholders under annuity contracts. However, under present law, income on nonqualified variable annuity (i.e., one that is not purchased as part of a qualified pension plan) may be taxed at the company level as well as at the policyholder level. Under present law, amounts credited to the holder of a nonqualified variable annuity based on appreciation in the value of the separate asset account are not deductible by the company. Thus, under present law, the company pays a tax at a capital gains rate on the sale of an appreciated asset, without an offsetting value of the separate account assets are not deductible by the company. Thus, under present law, the company pays a tax at a capital gains rate on the sale of the appreciated asset, without an offsetting deduction for the income credited to the contract- holder. When the income is distributed, it is taxable as ordinary income to the contractholder. The result is that amounts credited to a variable annuity that reflect the appreciation in value of assets in the separate account are taxed once at the company level at the capital gains rate and once to the contractholder as ordinary income. This double tax occurrence was recognized as appropriate in 1959 and again in 1962,[6] although it was eliminated for qualified pension contracts in 1962.

The provisions above do not cover the newer variable life insurance contracts. In the case of such accounts, there is no company level tax on amounts credited to contractholders that reflect the appreciation of the assets in the underlying separate account. Further, the company is allowed an ordinary deduction for such appreciation, whether realized or unrealized, when it is credited to the variable life insurance contract (and is reflected in reserves or the cash surrender value) and is taxed at the capital gains rate on the appreciation income when it is realized upon sale of the asset. As with other life insurance contracts, the policyholder will only be taxed on the income credited to the contract upon surrender to the extent the cash surrender value exceeds the investment in the contract (i.e., aggregate premiums paid, less any returned premiums, with no adjustment made for the cost of the current insurance protection received before surrender); if the contract terminates with the insured's death, the death proceeds are excluded from the gross income of the beneficiary.

Explanation of Provision

The bill retains the rules under present law that are applicable to variable annuities and extends those rules to apply variable life insurance contracts. Through an adjustment in the company's reserve deduction for variable contracts, any capital gain that is realized and reflected in the benefits under a variable annuity contract or a variable life insurance policy would be taxed at the company level before enjoying the usual tax treatment at the policyholder level. It could be argued that the proposal equalizes the tax treatment of insurance products based on investment funds and direct investment in such funds. In the case of "pension plan contracts" (i.e., contracts that are issued as part of a qualified pension plan), the company level capital gains tax is eliminated as it was under present law.

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[6] S. Rep. 291, 86th Cong., 1st Sess. 36 (1959); and S. Rep. 2109, 87th Cong. 2d Sess. 7-8 (1962).

Effective Date

The provision would apply to taxable years beginning after December 31, 1983.

C. Treatment of Distributions from Annuity Contracts

Present Law

An annuity contract issued by a life insurance company is a promise to pay to the beneficiary a given sum for a specified period, which period may terminate at death.[7] Annuity contracts permit the systematic liquidation of an amount consisting of principal (the policyholder's investment in the contract) and income. The insurance company takes the risk that such amount will be exhausted before the company's liability under the contract ends, but gains if the liability terminates before that amount is exhausted.

The starting date for annuity payments may be within one year after the initial premium is paid (an immediate annuity) or may be deferred to a later date (a deferred annuity). The period between the time the first premium is paid for an annuity and the time the first annuity payment is due is referred to as the accumulation period.

An individual may purchase an annuity by payment of a single premium or by making multiple premium payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin in exchange for the cash value of the contract. Partial surrenders are similarly permitted under some annuity contracts.

The taxation of interest or other current earnings on a contractholder's investment in an annuity contract generally is deferred until annuity payments are received or amounts characterized as income are withdrawn. Each amount paid to a contractholder as an annuity is treated in part as a distribution of income on the contract and, in part, as a nontaxable return of capital. In contrast to annuity payments, policy dividends paid after annuity payments begin are taxable in full to the contractholder as ordinary income.

Cash withdrawals prior to the annuity starting date are includible in gross income to the extent that the cash value of the contract (determined immediately before the amount is received and without regard to any surrender charge) exceeds the investment in the contract.[8] A penalty tax of 5 percent is imposed on the amount of any such distribution that is includible in income, to the extent that the amount is allocable to an investment made within 10 years of the distribution. The penalty is not imposed if the distribution is made after the contractholder attains age 59½, when the contractholder becomes disabled, upon the death of the contractholder, or as a payment under an annuity for life or for at least 5 years. Tax on the income that has accumulated under the annuity contract is deferred until there is a distribution of income, and the recipient of an annuity contract on the death of the contractholder stands in the shoes of the deceased contractholder, with the same investment in the contract.

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[7] If either the premium paid for an annuity contract or the annuity benefit under the contract is based on the investment return and the market value of a separate account established by the insurance company, the contract is generally a variable annuity contract.

[8] Under prior law, amounts paid out under a contract before the annuity payments began, such as payments upon partial surrender of a contract, were first treated as a return of the policyholder's capital and were taxable (as ordinary income) only after all of the policyholder's investment in the contract had been recovered.

Explanation of Provision

Penalty on premature distributions

The bill generally would retain the present-law provisions for annuity contracts. However, the 5-percent penalty on premature distributions (whether as a partial surrender, a cash withdrawal, or an annuity for less than 5 years) would apply to any amount distributed to the taxpayer before the age of 59½. The bill would impose the penalty tax without regard to whether the distribution is allocable to an investment made within the preceding 10 years.

The bill would limit the tax deferral benefits available to annuity holders on a basis that is more comparable to other sanctioned retirement savings programs, (*e.g.*, IRAs). The proposed repeal of the 10-year rule would be consistent with IRA plan rules under which distributions before age 59½ are subject to a penalty tax (although the penalty rate is 5 percent instead of 10 percent). As a result, emphasis is placed on annuities as a form of long-term or retirement savings to provide a taxpayer with an income that avoids the risk of his outliving the accumulation of assets.

Distributions or withdrawals from an IRA or redemption of retirement bonds are included in gross income for the year in which the distribution occurs. In addition, the amount of the distribution or withdrawals is subject to a 10-percent penalty tax if the distribution or withdrawal occurs before the individual on whose behalf the IRA was established attains age 59½. Premature distributions from an annuity, in contrast, are subject to a penalty tax of 5 percent—which is one-half of the 10-percent penalty tax on distribution from an IRA. The contribution or investment in a deferred annuity is made from after-tax income, but the $2,000 contribution to an IRA is tax-deductible.

The following table and explanatory discussion compares the after-tax investment return enjoyed by investors in savings accounts, IRAs, and deferred annuities, for taxpayers in 20-, 35-, and 50-percent marginal tax brackets. One may conclude from the table that the penalty tax can operate to discourage early withdrawals from a deferred annuity, but the deterrent effect is relatively short-lived, i.e., 5 to 7 years; there is no penalty tax on withdrawals if the taxpayer begins contributing to the annuity 5 or so years before the planned distribution date.[9]

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[9] Table 1 was developed to illustrate the effect of the penalty tax on premature withdrawals, and the interest rate assumptions may not reflect the relative interest rate structure of the assets that may be purchased currently by investors in these forms of savings. In addition, the tax-free benefits of an IRA are allowable on deposits up to only $2,000 a year.

TABLE 1.—YIELDS ON $2,000 PRE-TAX INVESTMENT IN ALTERNATIVE SAVINGS INSTRUMENTS AFTER TAX AND STATUTORY PENALTIES; 20, 35 AND 50 PERCENT MARGINAL TAX RATES

Year	20% marginal tax rates			35% marginal tax rates			50% marginal tax rates		
	Savings account	I.R.A.	Deferred annuity	Savings account	I.R.A.	Deferred annuity	Savings account	I.R.A	Deferred annuity
1	$1,754	$1,568	$1,744	$1,401	$1,232	$1,394	$1,062	$896	$1,054
2	1,922	1,756	1,905	1,511	1,380	1,499	1,127	1,004	1,114
3	2,107	1,967	2,086	1,629	1,546	1,616	1,197	1,124	1,182
4	2,309	2,203	2,288	1,756	1,731	1,748	1,271	1,259	1,258
5	2,531	2,468	2,515	1,893	[1] 1,939	[1] 1,895	1,350	[1] 1,410	1,343
6	2,774	2,764	2,768	2,041	2,171	2,060	1,433	1,579	[1] 1,438
7	3,040	[1] 3,095	[1] 3,053	2,200	2,432	2,244	1,522	1,768	1,545

[1] In all subsequent years, benefits from tax deferral accruing before withdrawal provide after-tax yields greater than after-tax yields on savings account.

Statutory penalties on premature withdrawal of tax-deferred income accruals are 5 percent from deferred annuities and 10 percent from I.R.A.'s.

12 percent rate of interest compounded annually.

No deferral on savings accounts. Initial deposit and earnings of IRA tax deferred until withdrawal. Initial deposit after-tax in deferred annuity, interest tax deferred until withdrawal.

Generally, a taxpayer who has been making contributions to an IRA or a deferred annuity will be better off after 5 to 7 years by taking a premature distribution and paying income and penalty taxes than he would be by depositing the initial $2,000 less income tax in a savings account or another bank investment on which interest would be taxable currently. The tax advantages outweigh the penalty in 5 years for a 50-percent marginal rate taxpayer with an IRA and in 7 years for a 20-percent marginal rate IRA owner. Before then, the accruals in a deferred annuity are similar to those of an IRA but yield a somewhat smaller after-tax advantage.

The investment of $2,000 is reduced by the applicable marginal income tax rate at the beginning of the first year, and the remainder is contributed to a deferred annuity or a savings account. The $2,000 deposit in the IRA is made tax-free. The interest income (assumed at 12 percent and compounded annually in each case) of the savings account is taxed at the end of the year when credited to the savings account. Tax is deferred on the interest income of the deferred annuity and the IRA until an early withdrawal is made, and at that time the appropriate marginal tax rate is applied to the total deferred income and the 5-percent (deferred annuity) or 10-percent (IRA) penalty tax for premature withdrawal also is levied.

Distribution in event of annuity holder's death

In the case of a contract other than a contract issued under a qualified plan, if the owner of the contract dies before the annuity starting date, an amount equal to the cash surrender value of such contract would be treated as paid to the contractholder immediately before death. Thus, the income in the contract would be subject to income tax in the decedent's return for the year of death. In order to avoid taxing the income on the contract twice, the amount includible in gross income of the decedent would be treated as a premium paid for the contract, giving the new owner a step-up in basis or additional investment in the contract. The 5-percent penalty tax on a premature distribution from an annuity would not apply to any amount includible in gross income because of the deemed distribution in the event of the contractholder's death. Thus, the bill would shift the incidence of the income tax on the income accumulated in a deferred annuity from the surviving beneficiary to the decedent contractholder.

This provision, in effect, reverses the income in respect of a decedent rules that would otherwise apply. Under income-in-respect-of-a-decedent rules, if a decedent taxpayer has earned income but such income is not received and includible in income prior to his death, the taxpayer who inherits the right to the income payment stands in the shoes of the decedent and includes it in income when received. Thus, the taxpayer who actually receives the income pays the tax thereon. Arguably, the reversal of the income-in-respect-of-a-decedent rules in this case may (in some situations) prevent the shifting of income from a high tax-bracket individual to an individual with a lower marginal tax bracket, as well as prevent the indefinite postponement of the payment of tax on accrued income.

The proposed treatment of annuity contracts upon death before the annuity starting date would differ also from that given, for example, to IRAs. Under present law, if the owner of an IRA account dies before distributions have commenced, the income in the account is taxable to the beneficiary under the following restrictions: (1) if the beneficiary is a spouse, the IRA account (together with tax deferral) can be continued until distributions must be commenced for the spouse; or (2) if the beneficiary is not the decedent's spouse, the account must be distributed within 5 years. The continued tax deferral for the spousal beneficiary recognizes that retirement savings may be intended to be used as retirement income for the married couple, while the limited continuation of tax deferral for nonspousal beneficiaries requires immediate recognition of some of the income while avoiding an unreasonable bunching of income in a single year.

D. Policyholder Loans

Present Law

Generally, taxpayers are allowed to deduct interest paid or accrued on indebtedness during the taxable year. However, no deduction is allowed for interest paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract. Similarly, no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in cash value of such contract.[10] If substantially all the premiums on a contract are paid within 4 years of the date on which the contract was purchased, the contract is treated as if it were a single premium contract. Further, if a purchaser borrows an amount equal to a substantial portion of the premium payments on a contract and deposits the borrowed funds with an insurance company to fund future payments on the policy, the purchaser is treated as having acquired a single premium contract.

The present law limitations on the deductibility of interest on debt incurred to purchase or carry certain life insurance products have their origins in the 1942 Revenue Act. Congress felt that the opportunity under prior law to combine the tax-free build-up of investment income in a life insurance policy and the current deduction of interest on indebtedness incurred or continued to purchase or carry the policy constituted a "considerable loophole" that could yield substantial tax advantages.[11] For example, if an individual purchased a single premium policy, borrowing all or a substantial part of the funds necessary to pay the premium on the policy, the annual increase in the cash value of the policy, apart from the premiums, could equal or exceed the net interest expense incurred by the purchaser. Where the annual increment in value of the policy exceeded the net interest cost of the borrowing, ownership of the policy could actually result in a net profit. In this environment, insurance companies were actually issuing policies under plans which contemplated that the taxpayer would borrow the premiums either directly from the insurer, or from a bank or other lender, and marketing these policies primarily on the basis that the policies were tax-saving devices.

In response, Congress enacted a provision to deny interest deductions with respect to indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. These limitations were extended in 1964 to preclude the deduction of interest on indebtedness incurred or continued to purchase or carry insurance pursuant to a plan of purchase that contemplates systematic borrowing. These changes resulted from a concern that policies were being sold to high bracket taxpayers who could afford to acquire large whole-life policies on the basis that the policies cost the individual little or nothing, and in some cases on the basis that the policies actually result in a net profit.[12]

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[10] Sec. 264(a)(1) also provides that no deduction shall be allowed for premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

[11] H.Rep. 2333, 77th Cong., 2d Sess. 47 (1942).

The importance of being able to borrow on insurance for other than tax-avoidance purposes was recognized, however, and Congress provided several exceptions to the rules disallowing the interest deduction. Under these provisions, a deduction is allowed if (1) no part of 4 of the first 7 annual premium payments due under the contract is paid by means of indebtedness; (2) the total of the amounts paid or accrued during the taxable year does not exceed $100; (3) the amount was paid or accrued on indebtedness incurred because of an unforeseen substantial increase in financial obligations; or (4) the indebtedness was incurred in connection with the taxpayer's trade or business. Under present law, if the requirements of any one of these 4 exceptions are satisfied, a taxpayer can deduct the full amount of interest otherwise deductible on an unlimited amount of indebtedness.

The 4-out-of-7 rule was designed to disallow the interest deduction in the case of a plan of systematic borrowing unless the loan proceeds were required for use in the taxpayer's business. However, current marketing techniques indicate that goal may not have been achieved. The result has been that the 4-out-of-7 rule provides a safe harbor under which it is still possible to sell policies on the basis of the tax savings that can be generated from the purchase of a policy, followed by the systematic direct or indirect borrowing of a substantial part of the increases in the cash value of such policy.

The following table is based on the structure of a policy that has actually been marketed and illustrates the advantages that can be obtained in combining tax-free inside buildup and maximum borrowings. An industry expert has indicated that this policy was designed for a 50 year old male using the 1980 CSO mortality table and a 4 percent assumed interest rate. The contract would endow at age 100. Given these assumptions, the contract would qualify as a life insurance contract under the provisions of S. 1992.

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[12] H.Rep. 749, 88th Cong., 1st Sess. 61 (1963); S.Rep. 830, 88th Cong., 2d Sess. 77-78 (1964).

TABLE 2.—ILLUSTRATION OF $500,000 PERMANENT LIFE INSURANCE PURCHASED FOR A 50 YEAR OLD MALE WITH MAXIMUM BORROWING AND DIVIDENDS USED TO BUY PAID-UP ADDITIONS

Year	Net after tax outlay	Cum. net after tax outlay	Annual loan	Loan interest at 10.3%	Cumulative loan	Net equity at surrender	Net death benefit	Guaranteed cash value
1	$14,454	$14,454	0	0	0	$280	$500,689	0
2	14,454	28,908	0	0	0	10,686	502,826	$9,500
3	745	29,654	$14,454	$1,489	$14,454	8,981	492,329	20,500
4	1,489	31,143	14,454	2,978	28,908	8,210	483,691	31,500
5	2,233	33,376	14,454	4,466	43,363	8,947	476,930	43,000
6	16,687	50,063	0	4,466	43,363	25,287	486,563	54,500
7	16,687	66,751	0	4,466	43,363	42,837	498,160	66,000
8	−35,394	31,357	54,910	10,122	98,272	8,356	458,554	77,500
9	807	32,164	19,724	12,154	117,996	11,175	456,522	89,500
10	730	32,895	20,876	14,304	138,871	13,908	455,608	101,000
20	−7,934	−6,507	47,082	49,387	479,487	44,348	475,581	217,500
30	−20,683	−154,953	97,079	123,864	1,202,559	94,078	536,856	319,500
40	−36,438	−438,887	185,363	268,940	2,611,069	182,915	614,939	397,500

Under this policy, a death benefit of $500,000 was provided and dividends were assumed, in the illustrations, to buy paid-up additions. The annual premium for a 50-year-old male was priced at $1[illegible],454 and maximum borrowing provided for in all but the first, second, sixth and seventh years. The issuer of the policy projected that the annual net after-tax cost of the policy would be in the $14,000 to $17,000 range in 4 of the first 7 years and below $2,300 in each of the other 3 years. After the eighth year, there would be no significant cost to the policyholder in continuing the policy. Starting in the eleventh year, the policyholder would experience a positive cash flow from the policy in every year. This occurs because the added amount that the policyholder may borrow from the increasing cash value of the policy exceeds the premium charges and the after-tax cost of the interest payable on the loan balance in those years. Beginning in the twentieth year, the policyholder's cumulative after-tax net outlay would be negative. Finally, if the policyholder were to die at age 80, the insurer's projections show a cumulative positive after-tax benefit to the policyholder over the 30 years of $155,000 and a net death benefit of close to $540,000. In that event, the policyholder would have realized a 12-percent net after-tax rate of return on the premiums invested in the policy.

Explanation of Provision

The bill would amend present law by adding a limitation on the amount of interest that is deductible. Amounts that are not deductible under present law would continue to be nondeductible under the bill.

The applicable limits

Individual policyholders and businesses owning policies insuring the lives of individuals would be allowed to deduct, for any taxable year, a limited amount of life insurance interest for such taxable year. Life insurance interest would be defined as interest paid or accrued in connection with a life insurance loan. A life insurance loan is any indebtedness if (1) the interest paid or accrued with respect to such indebtedness would, but for this provision, be deductible; and (2) the indebtedness is (a) incurred under, or secured by, a life insurance, endowment or annuity contract, or (b) incurred or continued to purchase or carry a life insurance, endowment or annuity contract. Thus, the provisions for limiting the deduction of interest under section 264 and under this bill would apply whether the loan is from the insurance company or a third party.

The amount that an individual policyholder could deduct in any taxable year (the applicable limit) would be equal to the product of $250,000 ($500,000 in the case of a joint return) multiplied by the interest rate for deficiencies (prescribed under sec. 6621) in effect as of the first day of the taxable year. The applicable limit for a business is the product of $500,000 multiplied by the deficiency interest rate for each insured that is treated under the bill as a qualified life.

Business taxpayers

For purposes of this provision, the $500,000 business limitation would apply to corporations, partnerships, proprietorships, or other entities engaged in a trade or business. As suggested above, businesses could deduct interest subject to an aggregate limitation based on the number of qualified lives.

Qualified lives are defined in the bill by reference to the amount of coverage provided an insured as a percentage of the maximum amount provided under other policies owned by the business. Under the bill, a qualified life would be an individual insured under a life insurance policy owned by a corporation, partnership, proprietorship or other entity engaged in a trade or business if (1) at some time during the taxable year the life of the individual is insured under a whole life policy owned by the business, and (2) the face amount of such policy is at least as great as 10 percent of the highest face amount of any whole life policy owned by the business and insuring the life of any other individual. Thus, if a corporation owns policies insuring the lives of three individuals, and the face amount of two of the policies is $1 million and the face amount of the other is $50,000, the individual with respect to whom the $50,000 policy is held would not be a qualified life. In such event, the corporation would be subject to an interest limitation of $1 million times the appropriate deficiency interest rate.

Carryover of unused limitation

Any excess limitation could be carried over and added to the limitation for the succeeding taxable year. Thus, if for any taxable year a taxpayer failed to pay or incur and deduct an amount of interest equal to the maximum deductible amount, the excess of the maximum amount over the amount that is deducted could be added to the maximum deductible amount for the succeeding taxable year. For example, assume that in a particular taxable year a individual not engaged in a trade or business borrows $10,000 at 8 percent and pays and deducts $800 of interest. If the deficiency rate under section 6621 for that year is 11 percent, the individual's unused interest limitation would be $26,700 (i.e., 250,000 X .11 - $800). If the deficiency rate is the same the next year, the individual's limitation for the next taxable year would be $54,200, (26,700 + ($250,000 X .11)) The unused amounts would carry over indefinitely. In reporting an identical provision, the Ways and Means Committee stated that no carryover would arise, however, with respect to a year in which there are no outstanding life insurance loans to the taxpayer or if the loans are on policies not covered by the new provisions adopted by the bill. Presumably, also the applicable limits described above apply regardless of the face amount or the cash surrender value of the policies (i.e., the applicable limit for an individual would be $250,000 multiplied by the deficiency interest rate even for a $10,000 face amount policy or for a policy with an available cash surrender value of $5,000).

Effective Date

The provisions of the bill relating to the deduction of life insurance interest would apply with respect to interest paid or accrued in taxable years ending after September 27, 1983. The provisions would not apply, however, to any indebtedness incurred under, secured by, or incurred or continued to purchase or carry a life insurance, endowment or annuity contract if such contract was issued before September 28, 1983, or was issued on or after such date pursuant to a binding contract entered into before such date.

E. Treatment of Group-term Life Insurance (Sec. 79)

Present Law

Employers often provide an amount of group-term life insurance protection to their employees as a fringe benefit. Such coverage is typically provided either as a fixed amount for each covered employee or as a set percentage or multiple of annual compensation for each covered employee. Some plans may provide for lesser or greater coverage for retired employees or may omit coverage of retired employees. Frequently, employees and retirees will be permitted to elect group-term life insurance coverage or other benefits.

Prior to the Revenue Act of 1964, the value of group-term life insurance provided by an employer for an employee was excluded from income by the employee. The exclusion of the value of group-term life insurance resulted from Treasury regulations rather than from a statutory mandate.[13] The Treasury justified this exclusion on the grounds that (1) the group-term coverage benefited the employee's beneficiaries rather than the employee, and (2) the benefits were characterized as contingent on the continuation of the employment relationship.[14]

In 1964, Congress determined that the tax-free receipt of group-term life insurance protection provided an employee with a substantial economic benefit and represented compensation that should be included in an employee's income. The 1964 Act, however, provided two major exceptions to this rule under which the cost of group-term life insurance coverage remained excluded from an employee's income. First, an exclusion was provided for the cost of up to $50,000 of group-term coverage. This exclusion was provided to encourage employers to provide basic life insurance protection to their employees. In addition, the absence of any transition rules in the 1964 Act suggests that the $50,000 limitation may have been intended to protect, indirectly, most then existing plans from the reach of the new limitations. The second major exception provided under the 1964 Act allowed retired employees to exclude all group-term coverage from income. This exception appears to have arisen out of a concern that an employee, who is no longer working, lacks a sufficient ability to pay tax on these benefits. This concern is also evidenced by the lack of transitional rules in 1964 Act.[15]

In TEFRA, Congress amended the group-term life insurance rules to deny the $50,000 exclusion when protection for key employees is provided under a discriminatory plan. However, because the nondiscrimination rules were drafted as a limitation on the

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[13] No comparable exclusion from income was ever provided for individual insurance or for cash value life insurance provided to employees.

[14] L.O. 1014, 2 C.B. 88 (1920).

[15] Exceptions were also provided for coverage under which the employer or a charity was designated as the beneficiary.

$50,000 exclusion, the rules do not affect group-term life insurance protection provided to retired employees.

These nondiscrimination rules provide that the income exclusion for employer-provided group-term life insurance applies with respect to a key employee only if the life insurance is provided under a program of the employer that does not discriminate in favor of key employees as to (1) eligibility to participate, or (2) the life insurance benefits provided under the plan.

A program of an employer providing group-term life insurance for employees generally is not considered to discriminate in favor of key employees as to eligibility to participate if (1) the program benefits at least 70 percent of all employees, (2) at least 85 percent of all participating employees are not key employees, or (3) the program benefits employees who qualify under a classification set up by the employer and found by the Secretary of the Treasury not to discriminate in favor of key employees. Alternatively, a program of an employer providing group-term life insurance which is provided under a cafeteria plan is not considered to discriminate in favor of key employees as to eligibility to participate if the eligibility rules for cafeteria plans are satisfied. Certain employees may be excluded when testing for nondiscrimination.

A program of employer-provided group-term life insurance for employees is not considered to discriminate in favor of key employees as to the benefits provided, if the program does not discriminate in favor of such employees with regard to the type and amount of the benefits. For this purpose, group-term life insurance benefits are not considered to discriminate merely because the amount of life insurance provided employees bears a uniform relationship to compensation.

When the cost of group-term life insurance coverage is includible in the income of an employee, that cost is determined on the basis of uniform premiums prescribed by the Treasury for 5-year age brackets ranging from age 30 to age 64. For employees age 64 and over, the age 59 to 63 cost is applied. The most recent premium costs prescribed by the Treasury are:

5-year age bracket	Cost per $1,000 of protection for 1-month period
Under 30	$0.08
30 to 34	.09
35 to 39	.11
40 to 44	.17
45 to 49	.29
50 to 54	.48
55 to 59	.75
60 to 64	1.17

Thus, an employee age 50 who receives $100,000 of group-term coverage recognizes $ 288 of income (50 x $0.48 per thousand of excess insurance x 12 months).

The social benefit of having an employer provide a minimum amount of life insurance coverage for wage earners on a nondiscriminatory basis may, in practice, not be achieved. For example, under present law, group-term insurance plans may be used as a means of withdrawing profits from a business by, or the building of an estate for, a retiring owner-employee. Likewise, a large amount of term life insurance provided under a group plan can be the basis of a nontaxable deferred compensation plan for key employees.

Explanation of Provision

The bill would effect three changes in the present-law treatment of group-term life insurance. First, the $50,000 limitation on the amount of group-term life insurance that may be provided tax-free to employees also would apply to retired as well as active employees.[16] The amendments would not alter the cost tables, however, so a retired employee's benefit would be computed at the age 65 cost.

Second, the nondiscrimination rules would be applied to plans covering retired employees. Thus, the cost of group-term coverage that is provided only to retiring key employees would not be subject to any exclusion from gross income. Third, under the bill, if a plan fails to qualify for the exclusion because it is discriminatory, then the employees and retirees would have to include in income the actual cost of their insurance benefit rather than the table cost prescribed by the Treasury.

Unless a plan is discriminatory, under the bill's provisions, a retired employee's benefit would be computed on the basis of the uniform cost tables. At age 65 the cost is presently $1.17 per thousand of excess insurance. Thus, a retiree age 65 who receives $100,000 of group-term coverage would recognize $702 of income which would have a maximum tax effect of $351. By contrast, the rate schedules of one major company set the premium for $100,000 of individual term coverage for a 65-year old male in excess of $3,000 per year.

Effective Date

The changes in the group-term life insurance rules made by the bill would not apply to any group-term life insurance plan in existence on September 27, 1983, with respect to covered individuals and to the extent of their coverage. Although on its face this provision grandfathers existing plans, several questions are left unanswered. For example, what would constitute a change in plan so that the resulting changed plan would not be considered to be in existence on September 27, 1983? Would an increase in coverage be a change in plans? Individuals coverage by the plan are grandfathered to the extent of their coverage: is that their present coverage as an active employee or the amount of coverage guaranteed to them upon retirement under the plan? Is the amount of grandfathered coverage limited to the present numerical amount coverage or would a coverage formula be grandfathered?

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[16] The bill would not apply the limitation to those who have terminated employment because of a disability.

F. Nondeductible Contributions to Individual Retirement Plans

Present Law

An individual generally is entitled to deduct the amount contributed to an individual retirement account or annuity (referred to collectively as "IRAs"). The limitation on the deduction for a taxable year generally is the lesser of 100 percent of compensation (generally net earnings from self-employment in the case of a self-employed individual) for the year or $2,000. The $2,000 contribution limit is increased to $2,250 for a year if (1) at least $250 is contributed to an IRA for the spouse of the employee, and (2) the spouse has no compensation for the year. Except for tax-free rollovers, no nondeductible contributions may be made to an IRA.

An annual excise tax applies to prohibited nondeductible contributions (*i.e.*, excess contributions) held in an IRA. The tax is 6 percent of the balance of the nondeductible contributions. Under present law, an individual is allowed a deduction from gross income for a taxable year if the individual corrects an excess contribution for a previous year by contributing less than the maximum amount allowable as a deduction for the year.[17]

Under present law, an individual is permitted to make a rollover contribution of a distribution from an IRA to another IRA without including the amount of the distribution in gross income. A tax-free rollover is generally allowed if the rollover occurs within 60 days after the date of the distribution. An individual is allowed to make a rollover contribution from an IRA once each year. Rollover contributions are not treated as excess contributions to an IRA and do not reduce the allowable deduction for a taxable year.

Income and gain on amounts held in an IRA are not taxed until distributed. Except in the case of certain correcting distributions or distributions rolled over to another eligible plan, all distributions from IRAs are includible in gross income when received. Distributions made before age 59½ (other than those attributable to disability or death) are subject to an additional 10-percent income tax. If an individual borrows from an IRA or uses IRA amounts as security for a loan, the transaction is treated as a distribution and the usual tax rules for distributions apply.

Distributions from an IRA must commence no later than the taxable year in which the individual attains age 70½, and special rules require distributions to be made within a prescribed time after the individual's death. Amounts held in an IRA can qualify for certain exclusions under the estate and gift tax rules.

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[17] The rule allowing a deduction for prior year contributions applies only to the amount of the excess contributions that do not exceed (1) the maximum allowable deduction for the year minus (2) the amounts contributed for the year.

Present law requires that the trustee or issuer of an IRA make annual calendar year reports relating to the status of the IRA.[18] This report must contain the following information for transactions during the calendar year: (1) the amount of contributions; (2) the amount of distributions; (3) in the case of an endowment contract, the amount of the premium paid allocable to the cost of life insurance; (4) the name and address of the trustee or issuer; and (5) such other information as the Commissioner may require. The annual report must be provided (1) to the individual on whose behalf the account is established or in whose name the annuity is purchased, and (2) to the Internal Revenue Service.

Explanation of Provision

In general

Under the provision, certain nondeductible IRA contributions (up to the nondeductible limit) would not be treated as excess contributions subject to the 6-percent annual excise tax. The nondeductible limit for a taxable year would be the least of (1) $1,750, (2) the excess of compensation includible in the individual's gross income for the year over the amount allowable as a deduction under the IRA rules, or (3) the amount of designated nondeductible contributions for the year.

Under the provision, a designated nondeductible contribution would be any contribution to an IRA for a taxable year that the individual designates as a nondeductible contribution, up to the nondeductible limit. The designation could be made or revoked up to the day prescribed by law for filing the income tax return for the taxable year, including any extensions of time for filing to which the individual is entitled.

In any case in which nondeductible contributions are made on behalf of an individual and an individual's noncompensated spouse (within the meaning of the spousal IRA rules), the nondeductible limit for the taxable year could be allocated in any manner. For example, an individual could make contributions of $875 as designated nondeductible contributions to the individual's IRA, and contributions of $875 as designated nondeductible contributions to the spousal IRA for the individual's noncompensated spouse. Alternatively, contributions of $1,750 of designated nondeductible contributions could be made to the spousal IRA.

Annual IRA contributions that exceed the sum of the amount allowable as a deduction for the taxable year and the nondeductible limit would be treated as excess contributions that are subject to the annual 6-percent excise tax. Under the provision, if contributions in a later taxable year, are less than the sum of (1) the amount allowable as a deduction for the taxable year, and (2) the nondeductible limit, excess contributions from the prior year could be applied against the remaining amount allowable as a deduction and the remaining nondeductible limit in the same manner as under present law. A designated nondeductible contribution could not, however, be recharacterized as a deductible contribution after the time for filing the tax return for the taxable year of the contribution (including extensions).

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[18] Treas. Reg. § 1.408-5.

Under the bill's provisions, any amount paid or distributed from an IRA would be treated, first, as paid or distributed from income and gain allocable to designated nondeductible contributions (to the extent thereof), second, as paid or distributed out of designated nondeductible contributions (to the extent thereof), and, third, out of other amounts. If an IRA distribution includes cash and property other than cash, the amount distributed would be the fair market value of the property plus the amount of cash distributed. If appreciated property is distributed, the gain allocable to designated nondeductible contributions would include the unrealized appreciation.

In general, any amount paid or distributed from an IRA is included in the gross income of the individual for the taxable year in which the payment or distribution is received. Amounts that are treated as paid or distributed out of designated nondeductible contributions, however, would be treated as a return of basis and would be excluded from gross income. Similar rules would apply to distributions under an individual retirement annuity and, therefore, the general rules relating to the taxation of distributions under individual retirement annuity contracts would be inapplicable.

For example, an individual's IRA could have accumulated designated nondeductible contributions of $10,000, income of $1,000 attributable to the designated nondeductible contributions, and other allowable amounts equal to $20,000. If the individual withdraws $15,000 from the IRA during a taxable year, $1,000 would be treated as coming from the income attributable to designated nondeductible contributions, $10,000 as attributable to the designated nondeductible contributions, and $4,000 as attributable to other allowable IRA contributions and income. The balance of designated nondeductible contributions under the IRA would be zero after the distribution. In this case, the individual would include $5,000 in gross income for the taxable year (*i.e.*, $15,000 minus $10,000 treated as a return of basis). In addition, if the withdrawal occurs prior to the time the individual attains age 59½, dies, or becomes disabled, $5,000 (the amount includible in gross income) is subject to the additional 10-percent income tax on premature distributions.

Recordkeeping and reporting requirements

The provision would permit both nondeductible and deductible contributions to be made to a single IRA. However, to ensure that the character of the contributions is retained, special recordkeeping and reporting provisions would apply.

One such provision would require an individual to designate the amount of nondeductible IRA contributions for a year. This designation could be required to be made to the trustee or issuer accepting the nondeductible contributions to aid the trustee or issuer in maintaining the records that would be required relating to the character of the amounts contributed. This designation would also assist the trustee or issuer in complying with the reporting requirements of the provision and with the annual reporting requirements of present law. With respect to the annual reporting requirement, the financial institution, when reporting contributions to IRAs, would specify the portion of any contribution that is a designated nondeductible contribution.

Under the provision, the individual's designation must be made not later than the time prescribed for filing an income tax return (including extensions). In order to assist the financial institution in maintaining records and meeting reporting requirements, the trustee or issuer would specify a date by which the designation must be made.

In addition, the provision would require the trustee or issuer of an IRA to maintain any records necessary to account separately for designated nondeductible contributions and for the income and gain attributable to designated nondeductible contributions. Under regulations prescribed by the Secretary of the Treasury, amounts rolled over, tax-free, from one IRA to another IRA would be required to be reported in a manner that would retain the character of the amounts as designated nondeductible contributions, income on designated nondeductible contributions, or other amounts.

Treasury regulations could require that the trustee or issuer of an IRA would provide a report to the individual on whose behalf an account is established or in whose name an annuity is purchased. This report could be provided to the individual at the time a payment or distribution is made from the IRA and could contain information relating to the character (*i.e.*, designated nondeductible contributions, income attributable to designated nondeductible contributions, and other amounts) of the amounts paid or distributed. In addition, a copy of this report could be required to be supplied to the trustee or issuer of an IRA to which a rollover contribution from another IRA is made so that the character of the amounts rolled over would be retained. Similarly, if a trustee-to-trustee transfer of IRA funds is made, any information relating to the character of the amounts transferred could be required to be supplied to the new trustee or issuer.

The report supplied at the time of a payment or distribution from an IRA would be required to be provided in addition to, and not in lieu of, the annual report required under present law.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1983.

Revenue Effect

It is estimated that this provision of the bill would reduce budget receipts as follows (for fiscal years 1984-1988):

[In millions of dollars]

1984	1985	1986	1987	1988
−15	−66	−141	−227	−321

Senator CHAFEE. Good morning. During the first session of this Congress, I was pleased to join with Senator Bentsen in introducing the Life Insurance Tax Act of 1983. This bill is identical to the proposal which was considered and approved by the House Committee on Ways and Means, also known as the Stark-Moore proposal. Both Congressman Stark and Congressman Moore will be testifying here today. I do not believe they are in the room at this moment. Is that true?

VOICE. Here they are.

Senator CHAFEE. Now you gentlemen may take your seats. We welcome you here and are very glad you came.

I introduced this measure originally to help bring this important piece of legislation to the attention of my colleagues so that the taxation of the life insurance industry could be decided as quickly as possible. Unfortunately, we were not able to complete work on the bill during the first session, but I hope we will be able to complete work on it early in this session. I know that time is of the essence in the matter.

The life insurance industry has been operating under a so-called stop-gap system of taxation while a substantial revision of the taxation of the industry is being considered and debated here. This stop-gap measure expired on December 31 of last year. Thus, there is considerable uncertainty as to the taxation of both the life insurance companies and their products.

The bill that is pending in the House and which Senator Bentsen and I introduced contains a complete revision of the very complex laws governing the taxation of life insurance companies, and represents the first such substantial revision since 1959. In introducing the legislation I, for one, made it clear that I did not endorse every single provision, but did give my support to the basic system of taxation established by the legislation and the major principles that are at the heart of this compromise proposal.

Today we will be examining not the whole act, but just the policy holder provisions. Specifically we will examine the definition of life insurance, the taxation of variable annuities and variable life insurance contracts, the treatment of premature distributions for deferred annuity contracts or death prior to annuitization, the limits on the amount of tax free group term insurance that can provided to retirees, the limitations on the deductibility of interest on loans secured by the cash surrender value of life insurance policies, and, finally, nondeductible contributions to individual retirement accounts.

These are very complicated issues. We have a host of witnesses so we are going to have to move along briskly. First I would like to emphasize one point. We must bear in mind that overhanging every measure that we consider in Congress in this session is the fact that our Government is spending each year $200 billion that we don't have. Now this is intolerable and, obviously, cannot continue. Thus, in this committee we will be guided not solely by what is helpful to retirees or helpful to annuitants or other groups but also by the needs of our Government to raise adequate funds to pay our bills.

I'm delighted that the very distinguished Senator from Oregon is here. And, Senator Packwood, if you have any comments, we would be glad to hear them.

Senator **Packwood**. Very briefly, Mr. Chairman, I compliment both the stocks and the mutuals and the administration and the House and I think the Senate on reaching a compromise satisfactory to all parties on the taxation of insurance companies generally. I applaud it; I support it. But I feel very strongly about the adverse provisions that are in the bill relating to the deductibility of interest on policyholder loans and the amount of those loans. I think with the definition of life insurance that has been agreed, 99 percent of the abuses that have been alleged will be eliminated. And to attempt to throw the baby out with the bath water and put in these severe limitations on policyholders is unfair. It provides the Treasury with next to no money. It's an asterisk. It doesn't even come up on that particular part of it to enough money to be dignified by a figure. And there is no point in striking out in that direction unnecessarily. If those proposed provisions are in the bill, Mr. Chairman, then I will oppose the bill, and I will do what I can to defeat it in committee and defeat it on the floor. I would hope we would take those provisions out. I have the votes, I think, to take them out. And that we go on with the main matter before us, which is the general taxation of life insurance companies.

Senator **Chafee**. All right, fine. Thank you very much.

Now we welcome Congressman Pete Stark who has been along with Congressman Henson Moore the leader of this effort in the House of Representatives. So won't you proceed, Congressman.

STATEMENT OF HON. FORTNEY H. STARK, U.S. REPRESENTATIVE, STATE OF CALIFORNIA

Mr. **Stark**. Mr. Chairman, thank you. It's a great pleasure to be here today to testify on the proposals concerning the taxation of life insurance products, and, the companies.

With me, of course, is Congressman Henson Moore who spent the last year working with me arduously and successfully, I think, on these difficult issues. We are pleased and flattered by the fact that two distinguished members of your committee—yourself, joined by Senator Bentsen—were agreeable to introducing the bill which we had developed without changes in the Senate.

From the beginning it was our intention to develop a complete replacement of the 1959 act, and we hope to remove many of the complexities and to streamline the provisions associated with life insurance taxation.

This task was made rather difficult by the disunity between the stocks and mutuals. You will see here today some stumbling and fumbling at this witness table as people who have not spoken to each other for over two years sit side by side—the stocks and the mutuals—to testify in favor of S. 1992. If they don't recognize each other, it's because they've been so long out of communication. And whatever we may have done on the House side was to reconcile some old friendships and the ACLI is now back in business.

Striking a balance between the segments of the industry was a difficult task, but one which we believed was reasonably successful, given the rather modest support of both sides. But they have come together and, I think, decided they were both equally disadvantaged. The House bill was a compromise they were willing and are willing to support.

I don't really want to discuss the specifics of the company provisions since they are not the subject of this hearing. But I am sure if there are any questions that you or the distinguished members of your panel may have, Mr. Moore would be glad to answer them. [Laughter.]

Representative **Stark**. I would comment on the policyholder provisions and with trepidation take exception to the distinguished gentleman from Oregon in that these, policyholder provisions, are an extremely important part of the overall package. Indeed, they run to the heart of the integrity of our tax system. Where we spend the taxpayers' money through tax expenditures there ought to be a good social reason. Or, indeed, a good economic reason, and that was the basis on which this bill was built. There was no good reason in law, in equity to give free inside buildup to shareholders any more than there is any good reason to give a complete income tax deduction for interest on savings accounts. There was a tradition in the life insurance industry that dates back to the turn of this century that allowed tax free inside buildup. The purpose of this is to carry a cash value reserve. And the reason the cash value reserves were originally there was at the insistence of the State commissioners, over the kicking and screaming and objecting of most insurance company. It was there to design a level premium, which was determined to be a socially significant value.

It was taking that in mind that we had traditionally forgiven interest on inside buildup that we built the policyholder provisions, deciding we would continue that very generous practice, but would make every attempt to close the loopholes through which wealthy taxpayers were avoiding paying their fair share of taxes.

The result after a great deal of long and hard arguing between ourselves and the affected parties, in our view, resulted in important reforms, and policy improvements over existing law. These consisted of provisions establishing a permanent set of tax rules defining life insurance, conforming the treatment of active and retired employees under section 79, which currently only governs the treatment of group term insurance provided to active employees, a limitation on the amount of interest that may be deducted on policyholder loans, modification—which I submit will not affect more than 15 or 20 people in the whole United States—modification of the rules affecting taxation on annuities and an increase in nondeductible contributions to IRA's. In addition we considered but did not resolve the question of variable life insurance.

I would like to briefly explain our rationale for these proposals. As you know, in TEFRA, Congress first established some specific guidelines as to what qualified a life product. These guidelines were limited, however, and they applied only to flexible premium policies. They left open the issue of company tax consequences in the event products failed the definition. And like most of the insurance provisions in TEFRA, expired at the end of 1983.

We felt that the principle of establishing upper limits on the investment in the contract relative to its insurance risk should apply to life insurance across the board. This is not too high a price to ask in light of the considerable tax benefits that we confer on life insurance.

Permanent rules in this area also benefit the life companies by providing certainty for product development. Section 79 limits to $50,000 the amount of group term life that can be provided to active employees as a nontaxable fringe benefit. There is, however, no limitation on the amount of tax free group term life available to retired employees. And this unlimited income exclusion can be provided on a discriminatory basis. We simply saw no valid reason why a difference should exist for retired employees. In fact, active employees normally have the greatest need for term life since this group is younger and normally have larger numbers of dependents in need of protection. Retired employees tend to have the least need for group term and providing no limitation merely leaves the door open for retiring employees who have considerable negotiating leverage with their employers to obtain large tax free benefits that would be unavailable to current employees. It's foolish to have a rule that provides the maximum amount of tax free group term life insurance to that group which probably has the least need for it. We also extended the nondiscrimination requirement to our section 79 changes to assure that these benefits are fairly distributed among the work force.

The bill provides that the 5-percent penalty on premature distributions from an annuity would be applicable to distribution prior to the age 591/2 rather than the previous rule which merely required a 10-year holding period. This change is intended to assure that the tax favored status which we provide to annuities really does result in long-term retirement savings rather than a shorter term tax deferral. The change, I think, reflects a desire on the part of the committee to bring a certain amount of comformity to the various tax provisions designed to encourage retirement savings. This change is consistent with requirements we have provided for retirement provisions such as the rules for premature distribution of IRA and Keogh plans. We also included a provision which provides for the taxation in the final return of a taxpayer of the deferred interest income of a deferred annuity if the taxpayer did not annuitize. We believe this bill is consistent with the overall policy justification of encouraging taxpayers to save for retirement while eliminating the ability of an individual to avoid income taxation completely by never annuitizing. We recognize that since the time the industry agreed to this provision there has been some suggestions that another approach to achieving the same goals be considered. We are amenable to considerir alternatives.

As I am sure you are aware, one of the most controversial provisions were the limitations we placed on the amount of interest that could be deducted on policyholder loans.

The limitation in the House and Senate bills is generally $500,000, which is extremely high. The number of policies affected is minuscule. A large stock life insurance company with 1,200,000 policies had only 172 loans in excess of even $50,000. I am attaching to our statement some materials provided to the committee which show the extremely small number of loans which would be impacted by this provision. Just to give you an example, a company with some millions of policies, 17 and 19 million, I believe had something like 600 loans or 800 loans that exceeded $50,000. And 600 of the 800 were to corporations, and 200 were to individuals. So even if you aggregated them all, you would find it very difficult to find many Americans who were affected by the provision. And it's interesting to note that a couple of enterprising young consultants who had just left the small company called Bendix under some prematrimonial discussions had organized a direct mailing campaign before the ink was dry on 4,170 offering options to corporations to buy insurance that would be backdated to 1983 and avoid the provisions of this act. This insurance could later be transferred to any employee they decided who could pass the physical, and the premium would then be determined. So the new loopholes were aboard even before this bill had really even seen the light of day on the House side. And I have no doubt that the major reason—and this was suggested initially by the Treasury who has seen many abuses in the area—was to block abuses, and did not create a golden egg that would encourage other people to use life insurance for what it was never intended, and that is to arbitrage tax deductions or create a tax shelter with really no vestige of savings or protections.

The number of loans, as I have said, is extremely small. The loan limitations serve two very important functions even though they seem astronomic. They put an upper cap on the amount of highly leveraged loans which an individual or corporation may have. We can provide you with ads, prospectuses which promote extremely large face value policies which are totally borrowed out in leverage through the use of the deduction for interest paid.

All responsible elements of the insurance industry admit that these kinds of highly leveraged policies exist merely on a cascade of tax benefits and they are abusive. In addition, a limitation on the amount of interest which could be deducted with respect to the life insurance loans is consistent with the tax policy established in respect to other tax favored investments. Thus, it is consistent with the prohibition contained in section 265 against deducting any interest on indebtedness incurred to purchase tax-exempt bonds, the limitation on the amount of loans which can be taken from qualified pension plans of $50,000 enacted as part of TEFRA, the prohibition against the deductibility of interest on indebtedness incurred to purchase all-savers certificates, and the general tax benefit rule.

The limitation contained in the bill also serves to insure that the proceeds of a life insurance policy are preserved. And, therefore, that the social policy goal which the tax-favored treatment of life insurance seeks to achieve is attainable. By way of example, if a $100,000 life insurance policy has a $90,000 loan, only $10,000 remains as death benefits. This defeats the purpose for which we provide the tax free inside buildup on a life insurance policy in the first place, because the proceeds of the policy would be consumed mostly to repay the loan rather than to be available to provide needed funds for the policyholder's beneficiaries. Mr. Moore and I feel strongly that this limitation is an important precedent in this area and it's perfectly consistent with the purpose for the tax deferred status of life insurance savings.

I will defer to Mr. Moore to discuss the changes in the amount of nondeductible contributions to IRA's since this was an issue for which Mr. Moore has fought long and hard.

Let me conclude by saying that we have been extremely cautious in the so-called policyholder provisions that we adopted as part of the House bill. None of them will have a dramatic negative impact on the industry or on its products. These changes are either designed to address abusive areas or to make conforming changes consistent with the generally accepted notion of good tax policy enacted elsewhere in the Code. They were, nonetheless, the product of considerable work, and political compromise and I certainly hope the Senate would accept these modest reforms.

As I am sure you are aware, taxation of life insurance companies and their products are issues which we address every several decades. This bill is an opportunity to make some limited changes in policyholder areas and, as you will all recognize, an opportunity which may not return for a long time.

And I would like to just for a moment thank my colleague from Louisiana, Mr. Moore, the assistant secretary of the Treasury, Mr. Chapoton, many of the members of the Joint Committee on Internal Taxation, the staff who are sitting with you today, the staff of the chairman of the Senate Committee, and the ranking minority member of the Senate Finance Committee who labored through most of the recesses all of last year. In some weeks we had over 15 members of the combined staffs putting in 40 hours of meetings. We had to meet with the segments of the industry separately. I suspect that hundreds of hours of staff consultation and meetings were held. I cannot think of a disagreement that wasn't resolved to the satisfaction of the Treasury, the minority, the majority, the House, with the Senate being informed each step of the way, and with the industry agreeing, it was a monumental tribute to the ability of the staff who serve us so well. And to your patience, to the members of the Senate Finance Committee, who I'm sure were dying of curiosity to know what the hell was going on on the other side of the Capitol with such frenetic deliberation—but it would be remiss of me not to thank all of those staff people, many of whom came from your side of the Capitol who helped us over many months. We appreciate it.

We think one of the paramount features of the bill is that there is some flexibility built into it in terms of simple adjustments. We suspect that you cannot change the traditions and the policies of 25 years now, in an industry that has been often tax motiviated, and suddenly completely change those rules of 25 years and not have overlooked something. At every step of the way, we wanted to design the major changes so that they could be adjusted if there was need for that in the future. And I think that's one of the features of the bill of which we are very proud.

At this time I would yield to Mr. Moore.

[The prepared statement of Congressman Stark follows:]

STATEMENT OF THE HONORABLE FORTNEY H. (PETE) STARK AND THE HONORABLE W. HENSON MOORE BEFORE THE SENATE FINANCE COMMITTEE HEARING ON THE TAXATION OF INSURANCE PRODUCTS

JANUARY 31, 1984

It is a great pleasure to be here today to testify on proposals concerning the taxation of life insurance products. With me, of course, is Congressman Henson Moore who spent the last year working with me arduously and successfully, I think, on these difficult issues. We are certainly pleased and flattered by the fact that two such distinguished Members of your Committee as Senator Benston and Senator Chaffee were amenable to introducing the bill which we had developed without changes, S. 1992. From the very beginning it was our intention to develop a complete replacement of the 1959 Act. We hoped to remove many of the complexities and to streamline the unique provisions associated with life insurance taxation. This task was made all the more difficult by the split in the industry between stock and mutual companies. Striking a balance between these two segments was a difficult task but one which we believe was reasonably successful given the significant differences between these two parts of the industry. As evidence of the consensus nature of the overall proposal, it was reported unanimously from both the Committee which I chair, the Select Revenue Measures Subcommittee, and the full Committee of Ways and Means. I will not discuss the specifics of the company provisions since those are not the subject of this hearing.

I would like to comment on the policyholder provisions which are in S. 1992 and H.R. 4170. These provisions are an important part of the overall package. They were the result of a great deal of long and hard bargaining between ourselves and the affected parties, and they represent, in our view, important reforms and policy improvements over existing law. These consist of provisions establishing a permanent set of tax rules defining life insurance, conforming the treatment of active and retired employees under section 79 which currently only governs the treatment of group term insurance provided by employers to active employees, a limitation on the amount of interest that may be deducted on policyholder loans, modification of the rules affecting taxation of annuities, and an increase in non-deductible contributions to IRAs. In addition, we considered but did not resolve the question of variable life insurance. I would like to briefly explain our rationale for these various proposals.

As you know, it was in TEFRA that Congress first established some specific guidelines as to what constitutes a qualified life insurance product. Those guidelines were limited, however: they applied only to flexible premium policies; they left open the issue of company tax consequences in the event products failed the definition; and, like most of the insurance provisions in TEFRA, expired at the end of 1983. We felt strongly that the principle of establishing upper limits on the investment in the contract relative to its insurance risk should apply to life insurance across-the-board. This is not too high a price to ask in light of the considerable tax benefits that we confer on insurance. Permanent rules in this area also benefit the life companies by providing some certainty for product development.

Section 79 limits to $50,000 the amount of group term life insurance that can be provided to active employees as a non-taxable fringe benefit. There is, however, no limitation on the amount of tax-free group term life insurance available to retired employees and this unlimited income exclusion can be provided on a discriminatory basis. We simply saw no valid reason why a different rule should exist for retired employees. In fact, active employees normally have the greatest need for term life insurance protection since this group is, of course, younger and normally have larger numbers of dependents in need of life insurance protection. Retired employees tend to have the least need for group term life insurance and providing no limitation merely leaves the door open for retiring employees who have considerable negotiating leverage with their employers to obtain large tax-free benefits that would be unavailable to current employees. It's simply foolish to have a rule that provides the maximum amount of tax-free group term life insurance to that group which probably has the least need for it. We also extended the non-discrimination requirement to our section 79 changes to assure that these benefits are fairly distributed among the work force.

The bill provides that the 5 percent penalty on premature distributions from an annuity would be applicable to distribution prior to age 59 1/2 rather than the previous rule which merely required a ten year holding period. This change is intended to assure that the tax favored status which we provide to annuities really does result in long-term retirement savings rather than shorter term tax deferral. The change, I think, reflects a desire on the part of the Committee to bring a certain amount of conformity to the various tax provisions designed to encourage retirement savings. This change is consistent with requirements we have provided for retirement provisions such as the rules for premature distribution of IRA and KEOGH plans. We also included a provision which provides for the taxation in the final return of a taxpayer of the deferred interest income of a deferred annuity if the taxpayer did nto annuitize. We believe this rule is consistent with the overall policy justification of encouraging taxpayers to save for retirement while eliminating the ability of an individual to avoid income taxation completely by never annuitizing. We recognize that since the time the industry agreed to this provision, that there has been some suggestions that another approach to achieving the same goals be considered which we are amenable to pursuing.

As I am sure you are aware, one of the most controversial provisions were the limitations we placed on the amount of interest that could be deducted on policyholder loans.

The limitation in the House and Senate bills which is generally $500,000 is extremely high. The number of policies affected is minuscule. A large stock life insurance company with 1,200,000 policies had only 172 loans in excess of even $50,000. I am attaching to our statement some materials provided to the Committee which show the extremely small number of loans that would be impacted by this provision. The number of loans in excess of $500,000 is rather small. These loan limitations, however, serve two very important functions. They put at least an upper cap on the amount of highly leveraged loans which an individual or corporation may have. We can provide this Committee with ads and prospectuses which promote extremely large face value policies which are totally borrowed out and leveraged through the use of the deduction for interest paid. All responsible elements of the insurance industry admit that these kinds of highly leveraged policies that exist merely on a cascade of tax benefits are abusive. In addition, a limitation on the amount of interest which may be deducted with respect to life insurance loans is consistent with the tax policy established with respect to other tax favored investments. Thus, it is consistent with the prohibition contained in section 265 against deducting any interest on indebtedness incurred to purchase tax-exempt bonds, the limitation on the amount of loans which can be taken from qualified pension plans of $50,000 enacted as part of TEFRA, the prohibition against the deductibility of interest on indebtedness incurred to purchase All-Savers Certificates, and the general tax benefit rule. The limitation contained in the bill also serves to insure that the proceeds of a life insurance policy are preserved and, therefore, that the social policy goal which the tax-favored treatment of life insurance seeks to achieve is attainable. By way of example, if a $100,000 life insurance policy has a $90,000 loan, only $10,000 remains as death benefits. This defeats the purpose for which we provide the tax free inside buildup on a life insurance policy in the first place, because the proceeds of the policy would be consumed mostly to repay the loan rather than to be available to provide needed funds for the policyholder's beneficiaries. Mr. Moore and I feel very strongly that this limitation is an important precedent in this area and is perfectly consistent with the purpose for the tax deferred status of life insurance savings.

I will defer to Mr. Moore to discuss the changes in the amount of non-deductible contributions to IRAs since this was an issue for which Mr. Moore has fought long and hard. Let me conclude by saying that we have been extremely cautious in the so-called policyholder provisions that we adopted as part of the House bill. None of them will have a dramatic negative impact on the industry or on its products. These changes are either designed to address abusive areas or to make conforming changes consistent with the generally accepted notion of good tax policy enacted elsewhere in the Code. They were, nonetheless, the product of considerable work, and political compromise and I certainly hope that the Senate would accept these modest reforms. As I am sure you are aware, taxation of life insurance companies and their products are issues which we address every several decades. This bill is an opportunity to make some limited changes in the policyholder areas and, as you will all recognize, an opportunity that may not return for a long time.

EXHIBIT 2-c

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August 25, 1983

MEMORANDUM

TO: Ways and Means Committee Staff Task Force on Life Insurance Company Taxation

FROM: William B. Harman, Jr.

RE: Policyholder Loans

Pursuant to your request, we have surveyed the member companies of the Stock Company Information Group to determine for each company the number of policies with loans in excess of $50,000. Attached is a table outlining the results of our survey. We will be happy to update the enclosed data as additional companies report this information to us.

POLICYHOLDER LOANS IN EXCESS OF $50,000
STOCK COMPANY INFORMATION GROUP COMPANIES

Company	Number of Policies With Loans Outstanding In Excess of $50,000 */	Total Number of Life Policies in Force	Percent of Such Loans To Total
I. Companies with Assets Greater Than $2 Billion			
1. Company A	1,251	374,000	.33
2. Company B	381	653,873	.06
3. Company C	172	1,200,000	.01
4. Company D	7	287,000	.002
5. Company E	249	275,000	.09
II. Companies with Assets Greater Than $1 Billion, but Less Than $2 Billion			
6. Company F	25	50,957	.05
7. Company G	227	1,329,500	.02
8. Company H	3	1,100,000	.0001
9. Company I	300 **/	2,600,000	.01
III. Companies with Assets Less Than $1 Billion			
10. Company J	0	1,000,000	0
11. Company K	11	1,200,000	.001
12. Company L	12	175,000	.007
13. Company M	15	1,163,000	.001
14. Company N	49	457,414	.01
15. Company O	4	233,000	.002
16. Company P	226	496,191	.05
17. Company Q	50	87,000	.06

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*/ Except in the case of Company I, these figures represent the number of policies with loans outstanding in excess of $50,000. Thus, such figures do not reflect any aggregation of policy loans per taxpayer.

**/ Number of taxpayers with policyholder loans totalling more than $50,000.

The Prudential Insurance Company of America
Corporate Office
Prudential Plaza, Newark, New Jersey 07101
Tel. 201-877-7751

Michael R. Chesman
Vice President and Tax Counsel

EXHIBIT 2-C

August 10, 1983

Mr. John J. Salmon
Chief Counsel
Committee on Ways and Means
Room 1102, Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Salmon:

In response to your memorandum dated August 1, 1983 to Bob Beck, attached you will find a corrected transcript of the testimony.

During the hearings, Mrs. Kennelly requested a "break-down" of Prudential policies with loans of $50,000 or more. Prudential has 1,060 policies with loans of $50,000 or more. Of these, 223 policies are owned by individuals and 837 policies are owned by corporations.*

If I can be of any further assistance to you in any way, please let me know.

Yours truly,

Michael Chesman

Vice President and Tax Counsel

MRC:LA
Attachment

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* - As of December 31, 1982, Prudential had 17,861,142 policies outstanding. Thus, policies with loans of $50,000 or more were less than .006% of total policies.

Senator CHAFEE. Before we do that, first of all, Congressman Stark, I want to thank you and of course Congressman Moore for this gargantuan labor that you undertook. We have been following your efforts with interest here in the Senate, and we appreciate all the work that you and your staffs put into this bill.

Now before we hear from Congressman Moore, I would like to hear from the cosponsor of this legislation, the distinguished Senator from Texas, Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman I would like to thank Senator Dole for holding these hearings early on this year. But I particularly want to thank Pete Stark and Henson Moore for the job they did, and join with you, Senator Chafee, that they put in incredibly long hours. It's a real problem when you have hundreds of life insurance companies and all with their own particular point of view in trying to establish a consensus, when you have got the intense competition between the mutuals and the stocks, and trying to be clear in the very complex field of insurance accounting that you have left the playing field relatively even in the competition.

I think the fact that this hearing is limited to the policyholder questions shows the general support for the rest of the bill, and that we have pretty well narrowed the differences and are ready to proceed. It really is the first permanent change in insurance tax legislation since 1959. It became obvious that the 1959 act just wouldn't work with the assumptions of low interest rates, which obviously no longer prevail. Then the insurance industry came in with MODCO to try to substantially lower their tax burdens. Some of them ended up, of course, without any tax.

Now the repeal of MODCO, of course, was something that had to be done, I think, but to turn around and do the relief on a temporary basis left them in an untenable position. So it's important that we move ahead now and try to establish a permanency in this tax legislation so they know how to price their products, and move forward in selling life insurance to the people of this country. I do say "sell" life insurance. People don't normally go and buy life insurance. They have to have their arms twisted and they have to let them smell the flowers and try to close the deal.

But I believe there are some things on the policyholder side that do need to be addressed here. I'm delighted that my friend from the State of Washington shares those concerns. I think you have got a situation on the variable annuities where you have a tendency to try to treat those companies in a discriminatory manner in this particular legislation that you end up in some situations where you have capital gains and a double taxation; and that we ought to try to see if we can't correct that kind of a situation.

When they tried to talk to me about something really like mutual funds, yes, I think part way. But I think on the other side of it with the definition that you are bringing about in life insurance, that you are able to protect that situation, and the multiples of life coverage as related to cash values and reserves goes a long way to protect the abuses that might occur otherwise, and will tend once again to push and see if people will buy life insurance primarily for protection, and life insurance as it has been historically known.

I'm delighted, Mr. Chairman, that we are able to get underway here. And I will look forward to questioning Secretary Chapoton on some of these questions involving policyholders as we go along.

Senator CHAFEE. Thank you very much, Senator Bentsen. Of course, you have been long a leader in this effort, and we look forward to working with you as we try to finish this. I share your sense of urgency. I think the industry is entitled to know what their tax rate is going to be, So we are going to try to move this legislation along as rapidly as possible.

We are delighted to have the distinguished Senator from Montana here, Senator Baucus. Senator, do you have a statement you would like to make?

Senator BAUCUS. Thank you, Mr. Chairman. Yes, I just have a couple of points. And I share the opinion of those who spoke before—that is about the urgency of this bill.

I just have two points to make. One, I hope it doesn't get caught up as hostage in IDB's and home mortgage revenue bonds and so forth and other such things. It seems to me that this bill is important on its own, has to move on its own. I just very much hope the proponents of the bill as well as proponents of other legislation do not let their other wishes get in the way of this.

Mr. STARK. I think the Senator is preaching to the choir in this instance.

Senator BAUCUS. I know the Senator is preaching in part to the choir. He's also preaching to some heretics too who may be in the audience at the moment.

Two, it is possible that there may be some changes in this bill. I know Pete and Henson did a good job in airing out a lot of these differences and coming up with a virtual agreement. I also know that Senator Chafee and Senator Bentsen have done the same.

However, I hope consistent with the view of getting this bill passed quickly this year that sponsors of the bill also are amenable to some minor little changes to make the bill even better than it now is. But I again applaud your efforts. You have done a great job.

Senator BENTSEN. I just want to apologize to you, Mr. Chairman, for being about 5 minutes late. The last thing I heard on the floor last night was that this had been moved to 10. Probably some of the fellows don't get the message.

Senator CHAFEE. If our colleagues were only 5 minutes late in this body, we wouldn't be in bad shape at all. [Laughter.]

And now we are delighted, of course, to hear from Congressman Henson Moore who has worked so closely on this and so arduously.

So, Henson, why don't you go ahead.

STATEMENT OF HON. W. HENSON MOORE, U.S. REPRESENTATIVE, STATE OF LOUISIANA

Mr. MOORE. Thank you, Mr. Chairman. I want to thank the opportunity to be here today and testify on this bill. I appreciate your subcommittee taking it up so quickly.

I would like to join with my colleague, Pete Stark, and say I thank him for inviting me to work on this project. It certainly was a pleasure working with him and with Buck Chapoton and the staff, and Senate Finance Committee, and the Joint Committee and our own Ways and Means Committee. It was one of the most gratifying experiences I have ever had in terms of trying to write a bill the right way.

I agree with everything my colleague, Pete, has testified to this morning. I would like to just for a moment say a few words in support of what he was talking about in the policyholder provisions.

I would urge the gentlemen of the Senate, that even you are certainly going to make changes and probably make some good changes to the bill, that's why we have two houses and legislative bodies; people to look at the work we have done and improve on it—that before you take those provisions out and cast them aside entirely on the idea of coming back to this maybe at a future date, consider this, Pete and I have been in that hot seat. I am going to tell you that when you take on all of the insurance agents in the country in talking about changing the taxation of life insurance policies, you are taking on quite a formidable group, and rightly so. What I'm saying is I wonder if either body will ever muster the political courage to get into this issue again. We've been into it now and we have taken a tremendous amount of pressure both at home and nationally and have finally worked out a compromise satisfactory to the mutuals, the stocks, the small insurance companies, and notably both of the life insurance agent organizations. We now have a compromise that all are in agreement with. Now I understand there are some splintered groups of agents and perhaps companies that aren't in favor of that, but I don't think you are going to ever find unanimity on anything. We have come about as close as you can on these provisions.

I simply caution that when these provisions are cast aside, to ever get back into this another day is going to be a very difficult thing to do. I rather imagine it will never be done on our side of the Capitol. I don't know about over here. I don't think anybody is going to want to get into that again.

When you look at the situation and we will leave it to Secretary Chapoton to lay out before the committee the evidence, that there is a problem, a problem that can't be handled definitionally and isn't handled in the law now. And those problems convinced us that there was a need to do something, but Not to interfere with the average policyholder, and by the high limit we have drawn, not even to interfere with the extraordinary policyholder. We are talking about a very, very small, select group of people that would be affected by these provisions. I think when he finishes showing you what he has shown us, you will see why there was total agreement on our subcommittee and the full committee that something needed to be done. We looked at definitional approaches and could find no way to handle it other than the way we have done. Perhaps the Senate can find a better way. But I think there is a problem and would urge you to look long and hard before you cast it out and say perhaps there isn't one.

Since we have drawn those provisions, I've had many companies and many agents come to me privately and say what they could not say publicly because they were working with one group or another. They have said that we were dead right, that they have seen the abuses and know they are there. It's not part of a normal insurance business. It's not part of an insurance business at all. They think we are totally and properly right in addressing the issue. And if anything, the solution we came up with was most, if not understatedly, lenient in trying to address what is in all probability a problem.

Senator CHAFEE. You are talking specifically about the loans?

Mr. MOORE. Yes I would like to touch briefly now on a provision of the bill that has been deferred to me by my subcommittee chairman. That's a provision for nondeductible contributions for individual retirement accounts, something that has interested our chairman here today, Senator Chafee, a great deal in the past.

This provision would permit nondeductible contributions for the first time to individual retirement accounts of up to $1,750 per year after the maximum deductible contributions are made. Two econometric studies we had commissioned in the past showed that this provision alone would add something like $7 billion a year in permanent long-term savings, which would offset $7 billion in additional borrowing of the Federal Government or the deficit. Increasing savings is one of our solutions of our problem of big deficits.

The need to encourage increased savings in the United States cannot be understated. I should also indicate the change is clearly appropriate as part of this bill to revise the taxation of life insurance products and their companies because a nondeductible IRA is virtually the economic equivalent of a tax deferred annuity. The changes that we have in the bill now with respect to the tax deferred annuities, causing them to conform to IRA's, caused us to look at the IRA, and cause it to conform more toward the tax deferred annuity. Right now you can make nondeductible contributions, obviously, to tax annuities. You can do the same thing to Keogh plans and to pension plans. Only in the workingman's tax shelter, the IRA, the workingman's saving plan—you cannot do that. And so we provided for that in this bill. It's a very, very modest revenue loss to get in turn what we think very conservatively will be a minimum of $7 billion a year in additional savings. So I would urge the committee to hopefully favorably consider retaining that provision that we have in the House bill.

Thank you, Mr. Chairman.

[The prepared statement of Congressman Moore follows:]

STATEMENT OF THE HONORABLE W. HENSON MOORE
BEFORE THE SENATE FINANCE COMMITTEE
HEARING ON THE
TAXATION OF LIFE INSURANCE PRODUCTS
JANUARY 31, 1984

MR. CHAIRMAN, THANK YOU FOR THE OPPORTUNITY TO TESTIFY HERE TODAY ON THE PROPOSALS CONCERNING THE TAXATION OF LIFE INSURANCE PRODUCTS. I WILL NOT DISCUSS THE SUBJECTS COVERED BY MY COLLEAGUE, PETE STARK, OTHER THAN TO INDICATE THAT I FULLY SUPPORT HIS STATEMENT. I WOULD LIKE TO TOUCH BRIEFLY ON ONE PROVISION IN THE BILL WHICH HE HAS DEFERRED TO ME, THAT IS, THE PROVISION PROVIDING FOR NON-DEDUCTIBLE CONTRIBUTIONS TO INDIVIDUAL RETIREMENT ACCOUNTS. THE PROVISION WOULD PERMIT NON-DEDUCTIBLE CONTRIBUTIONS OF UP TO $1,750 PER YEAR AND WOULD THUS PROVIDE AN ADDITIONAL INCENTIVE FOR NEW SAVINGS. TWO ECONOMETRIC STUDIES, COMMISSIONED AT MY REQUEST, FIND THAT THESE PROVISIONS WOULD ADD APPROXIMATELY $7 BILLION TO THE NATION'S SAVINGS POOL ANNUALLY. THE NEED TO ENCOURAGE INCREASED SAVINGS IN THE UNITED STATES CANNOT BE UNDERSTATED. I SHOULD ALSO INDICATE THAT THIS CHANGE IS CLEARLY APPROPRIATE AS PART OF A BILL TO REVISE THE TAXATION OF LIFE INSURANCE PRODUCTS AND THEIR COMPANIES BECAUSE A NON-DEDUCTIBLE IRA IS VIRTUALLY THE ECONOMIC EQUIVALENT OF A TAX-DEFERRED ANNUITY. THE CHANGES THAT HAVE BEEN MADE WITH RESPECT TO THE TREATMENT OF TAX-DEFERRED ANNUITIES TO CONFORM THEIR TREATMENT TO THAT OF IRA'S ONLY SERVES TO BRING THESE TWO INVESTMENTS CLOSER TOGETHER. AS A RESULT, I STRONGLY URGE YOUR COMMITTEE TO FAVORABLY CONSIDER THESE PROVISIONS.

Senator **Chafee**. Congressman Moore, what would be your attitude on the IRA's that you have got, the nondeductible $1,750, I think—isn't it?

Mr. **Moore**. Yes, sir.

Senator **Chafee**. In light of the President's recommendation the other evening that we allow a spousal IRA deduction of $2,000?

Mr. **Moore**. I'm in complete support of the President's plan for doing that. I've introduced that bill on the House side after he came out with it last year. That shouldn't affect this provision. You still should have an IRA conform and be similar to and competitive with an annuity—competitive with a Keogh plan and private pension plans which still allow the nondeductible IRA. The spousal IRA rates doesn't help a single taxpayer, and it doesn't help two working taxpayers. It only helps the nonworking spouse. And so there is no conflict. We ought to have both of them. And if this committee finds it can afford to go ahead and pass the spousal IRA, that would be fine. This nondeductible IRA is so slight in its additional loss of money to the Treasury that there is room for both.

Senator **Chafee**. Does this $1,750 nondeductible apply to the spouse too under your proposal? In other words, for a married couple with only one wage earner—and let's say the husband is the wage earner—under your proposal would he have his $2,000 deduction plus the $1,750.

Mr. **Moore**. He would have $2,250 if he wished to open a spousal. But the individual would be $2,000 plus $1,750. That's correct.

Senator **Chafee**. Seventeen fifty nondeductible.

Mr. **Moore**. Correct.

Senator **Chafee**. Now let's say the President's proposal passed, and the nonworking spouse could have a $2,000 IRA.

Mr. **Moore**. Correct.

Senator **Chafee**. Now what about the $1,750 as regards her?

Mr. **Moore**. As of now there was no spousal $2,000 IRA. What we did provide in this bill is that in the case of a spousal IRA of $2,250—Pete Stark suggested to me we make the figure $1,750 instead of my earlier suggested figure of $2,000 so you would have $1,750 plus $2,250 which would equal $4,000, and each spouse would then have a $2,000 IRA. So you have to check with the counsel. I'm not sure legally where we stand if we now pass a full $2,000 deductible IRA for a nonworking spouse and how this would apply. I should think that spouse should be the $1,750 also. But I'm not sure the language we have, in the bill now would cover that. By the time we drew it of course—we were talking about existing law of IRA's.

Senator **Chafee**. Now do I understand from your testimony that you have got the life insurance agents' support, for this bill, including the policyholder provisions?

Mr. **Moore**. The two major groups are aboard on this provision. They worked with us very closely on it. They are still sold. They are honorable people. They have stood with the bargain we have made. And they are willing to live with these provisions. As far as I know, there has been no change in their attitude. I have not had any agents talk to me to the contrary, but I understand from the staff that there are some agents who are not part of these two groups or refuse to go along with these two national organizations and who are in disagreement.

Senator CHAFEE. Do you know who opposes the policyholder provisions in the bill?

Mr. STARK. Senator Chafee, Mr. Chairman, they literally wrote letters of support. It was an official endorsement in writing by both of the two major agent groups for the provisions of the bill as you and Senator Bentsen introduced them, as we introduced them in the House

Mr. MOORE. If you look at our earlier attempts in this area, Senator, the earlier figures we came up with were a great deal more restrictive, in the order of the magnitude 10 times more restrictive than what is there now, and it was working with the agent groups that ultimately got us where we are now.

Senator CHAFEE. I would like to clarify that even these increased limits on borrowing are cumulative. In other words, as I understand it, if you borrow say $10,000 one year, you have only used up $240,000 so the next year you have $250,000 plus $240,000?

Mr. MOORE. That's correct.

Senator CHAFEE. No one can say that's onerous.

Mr. MOORE. And in the case of corporations, it's per insured. Not the $250,000 limit per corporation but per insured within that corporation. So they may well have 15 employees that $250,000 loans and they have not exceeded their limitation.

Mr. STARK. We have looked for the cases that we would exclude. [Laughter.]

We haven't found one yet, Mr. Chairman.

Senator CHAFEE. I don't think you caught many on that one.

All right. Senator Packwood.

Senator PACKWOOD. Pete, let me ask you this. I know all the groups agreed to the compromise. You read off the list of the number of policies that are involved and they are relatively slight. My hunch would be that 95 percent of the agents are not involved in writing the kind of policies you mentioned so I can understand why they signed off on it. They are just not in the business.

Mr. MOORE. Sir, if you had met with my agents, as I did, in Louisiana and as Pete did with the national organizations, every agent in the country would have you believe that if he is not writing it, he hopes to write it. And, therefore, that agent felt very strongly about these provisions. [Laughter.]

Mr. STARK. Senator, that's how that agent was recruited in the first place because tomorrow he is going to write that policy, and you don't want to get in his way.

Senator Packwood. Hope may spring eternal, but I know a lot of 50 year old agents who haven't written a policy like that yet. And if they haven't written it yet, they are not likely to in the remaining useful years of their life.

Let me reverse the question. If the policyholder provisions were eliminated or modified do you know any of the groups that are participants to the compromise that would drop off?

Mr. STARK. No. I don't think they would. [Laughter.]

But I do think that having tasted respectability and responsibility that they find it interesting to be on the side of an equitable tax program. And they might enjoy continuing to play in that arena albeit on a limited basis.

Senator CHAFEE. How many out of 100?

Senator PACKWOOD. It's also amazing how many people are willing to be decent, fair and equitable when it doesn't affect them and it only affects somebody else.

Let me go further. You had two issues you raised on this—fairness, revenue. Aside from the fact that the definition of "life insurance" that we will adopt, I think, will absolutely eliminate most of the abuses, let's forget that for a moment. Isn't it true that even without that definition the amount of revenue you are talking about is slight?

Mr. STARK. Senator, I would leave that at some point to Secretary Chapoton. But if I could suggest that prospectively the abuses become phenomenal and that is because we have only seen interest rates in the neighborhood of exceeding 10 percent for a few years.

Senator PACKWOOD. But the administration projects those are going to be down for the next 5 years.

Mr. STARK. I submit that even with their optimistic projections that we won't see prime rates in single digits for the foreseeable future. And it provides with enough volume pure arbitrage. Even if you take the most old-fashioned, traditional, ordinary life without the extremely high cash value, you provide the system whereby over a certain period of time—somewhere between 5 and 15 years, depending on the volume—that you can have a net positive cash flow. If you are in the 50-percent marginal bracket and you have got a 10-percent spread, that is, 10-percent interest return of an 11 percent loan, you can generate huge positive cash flows to yourself by arbitraging deductions. And to allow that system to exist is only to encourage it to expand. We are trying, in a sense, to nip that practice in the bud.

Senator PACKWOOD. And you are saying that is going to happen even if we define life insurance in the bill.

Mr. STARK. Yes, sir.

Senator PACKWOOD. Well, in that case, your argument runs to anybody that borrows against life insurance and any amount. I don't mean $50,000 or $100,000.

Mr. STARK. Who borrows in the kind of persistent practice and could arrange the kind of loans, floating loans, could do that. That is correct.

Senator PACKWOOD. But if you define "life insurance," as I think we will, then you are not going to be able to arbitrage it. To use your word, you might be able to have a $500 or $700 or 1 million policy and you can borrow great quantities of money, but proportionately no greater than somebody with a $30,000 policy could borrow.

Mr. STARK. I suspect, and I would have to calculate, the exact figures on that, but I doubt very much if there is a cash value policy that would be competitive in the market that you couldn't arbitrage at the 50-percent margin.

Now it's conceivable when you get down into the 30-percent margical brackets, in smaller amounts, that the arbitrage would disappear. But I would say at the 50-percent rate I could probably calculate for you an arbitrage on most any policy that is actually on the market today.

Mr. **Moore**. Senator, if I could add for a moment. I think you are quite right when you discuss the amount of revenue loss we are dealing with here is insignificant now, although I agree with Pete this could become a real problem in the future. The problem we were looking at is simply this. We have allowed in the case of a life insurance policy a double dip in the tax till on the inside build up tax free, and then being able to write off the interest when you borrow against that. We don't do it in the case of tax exempt bonds. You cannot borrow the money and write off the interest to buy tax exempt municipal bonds. You can't do it to buy an all savers certificate which is tax exempt interest income. And you can't do it on qualified pension plans.

So then we ask the question, well, why can you do it against an insurance policy when we saw the kind of abuses the Treasury brought forth? And we finally decided upon a level that was simply a political level, one worked out with the agents as being acceptable.

And so we set that limit so high that no one is talking about an average policyholder. We are talking about some very, very few people, if any. We are not sure we have hit anybody yet. But if we are, they are so extraordinary that you look at the abuse involved and we think it is so significant that you just can't turn the other way on it.

Senator **Packwood**. Well, I will conclude with this. I think we can cure the abuse. And then the only issue is largeness and there is no inherent immorality in largeness.

Mr. **Moore**. I say again, I think it's just a practical decision. In theory there shouldn't be a loan probably against an insurance policy at all where you write off the interest from it. We don't do it for these other investments that I just went over that are tax deferred, and tax favored. But as a practical matter, we are not going to do that and nor are you. And so we tried to come up with something reasonable.

Senator **Packwood**. Thank you, Mr. Chairman.

Senator **Chafee**. Senator Bentsen.

Senator **Bentsen**. That part is of some concern to me. I think Pete and Henson are familiar with it. I think we should try to conform the companies for tax treatment for an amount set aside or paid to the customers' benefit under the variable life insurance benefit and the variable annuity contracts with that that you have for fixed benefits.

Mr. **Stark**. Senator, I would in principal be inclined to agree with you. We felt there and we tried to where the products lapped over into becoming very investment oriented products—we decided that in the new thrust toward financial institutions taking on new character and providing new products in all phases of the financial markets that we ought to try and provide a level playing field. There was some strenuous objection to that provision from the mutual fund industries. And on the basis—there wasn't complete parity there. And we were willing to stand aside on that issue and say maybe the way to solve that is to tighten up our mutual funds or to loosen up our mutual funds and provide a similar loosening to the variable products. As I say, in philosophy you are right. The question is they don't get quite the same advantage there. And to the extent that they will become, I suspect, more competitive, and rightly so—I think that the life insurance industry was hampered for a long time by inflexibility in its outlook toward its product and perhaps by laws which prohibited its product from taking on the character it has now.

I, personally—and I've tried not to let that get involved in writing this bill—but I personally think a variable investment type of life insurance product is a good consumer product. On the other hand, I have always felt that mutual funds were as well. And I think that in the long range there has got to be some attempt to not disadvantage one against the other in the Tax Code. And we have not achieved parity in this bill, and would welcome some adjustment.

But I don't think you can do that in complete disregard of the mutual fund industry.

Senator **Bentsen**. No, I agree. And it has been a long time since I've cheered a mutual fund company. But I do think that I recall on the mutual fund side that the capital gain category carries through for the investor where in this other situation you are talking about switching it over and treating it as ordinary income. And that, too, would be a disparity.

Mr. **Stark**. There is some deferral in the insurance contracts, however, that the mutual fund doesn't necessarily get. And that may balance out. And as I say, it's an area that we passed over rather than made a decision that we would move one way or the other because of the controversy in that area. I would be most amenable if the Senate, in its deliberation, could find a compromise that would not destroy the rest of the bill by its opposition. I would be willing to entertain a reasonable compromise in that area. That's my own personal feeling.

Senator **Bentsen**. Well, I would hope that the Secretary of the Treasury is hearing the aid and comfort I am receiving from the two distinguished House Members in that regard. [Laughter.]

Senator **Chafee**. Senator Moynihan, we welcome you here. Do you have a statement?

Senator **Moynihan**. No.

Senator **Chafee**. Fine. Gentlemen, thank you very much for coming. We appreciate all the work you have done on this.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Senator **Chafee**. Mr. Chapoton.

Secretary **Chapoton**. Thank you, Mr. Chairman. I will try to be brief.

Senator **Chafee**. Do you have a written statement?

Secretary **Chapoton**. Yes, sir. We have a rather lengthy statement, as a matter of fact.

Senator **Chafee**. You do have a statement. There is no question about that. [Laughter.]

Seventeen pages, single spaced. We will permit you to summarize.

Secretary CHAPOTON. I will summarize it very quickly. I think I will dwell a bit on the policy on the loan provisions.

First, in the definition of "life insurance," let me just point out, because it relates to points that I want to make later, that we all know that there are two components to a whole cash value life insurance package. There is the investment component and the insurance protection. And, of course, we know when we refer to interest that is credited on the investment portion of the investment component we are talking about the inside build up on a policy. There are two significant tax benefits. There are a number of tax benefits in life insurance, but two significant ones. The first is the fact that the death proceeds are excluded from income, including any inside build up represented, and the failure to impose any current tax on the inside build up as it is earned and credited to the taxpayer, to the policyholder.

My statement goes through the application of the development of the definition of insurance to make certain that overly investment oriented products do not receive the blessing as an insurance policy in the tax benefit allowed insurance products. That came about in TEFRA. The TEFRA limits were applied only to flexible premium policies. The definition in the bill before you tighten slightly on the definition in TEFRA and also applies to the definition to all policies whether flexible, premium or otherwise. And, basically, we are supporting the definition in S. 1992.

Annuities, dealing first with normal annuities, that is, straight annuities, deferred annuities, not variable annuities. The bill would apply the 5-percent penalty application under existing law if there is early withdrawal, early distribution, from an annuity. It removes the limitation that no penalty is applied if the distributions do not start until, 10 years after the policy is contracted for. We agree with S. 1992 in that regard. We would simply point out that a 5- percent penalty is not unduly harsh and that a customer policyholder who withdraws income from the deferred annuity after as little as five years frequently will have more income after the tax and the penalty than a taxpayer who left the funds in an investment that was subject to tax currently. So we do agree with the change in S. 1992.

In the variable life and variable annuity area, we point out that there are a number of aspects to this variable products or relatively recent developments, variable annuities developed in the 1950's and variable life insurance developed in the 1970's. Under S. 1992, both the variable life and variable annuities are subject to a rule that imposes a tax at the company level on capital gains and then a second tax is imposed on that capital gain income at ordinary rates at the policyholder level when distributions are made under variable annuity contracts or when the policy is surrendered in the case of a variable life insurance contract.

The life insurers industry has argued that this discriminates against their products, as Senator Bentsen mentioned, to such an extent that the products cannot effectively compete, and that they wish to sell capital gains oriented variable annuities and think these limitations should be removed.

We have looked at this problem in some depth. It is a difficult competitive problem, but we cannot support the elimination of the corporate level capital gains tax imposed under S. 1992 in connection with variable annuities. While life insurance companies have traditionally sold fixed income investments on a tax deferred basis, both life and insurance annuities, they have not sold capital gains oriented investments through variable annuities. In this period of increased financial deregulation and increased competition among financial intermediaries, we see no basis for expanding the range of tax favored investment that the life insurance industry may sell. A change in the current treatment of variable annuities could significantly shift competitive balances among various types of financial intermediaries in favor of the insurance companies and cause significant loss to the Treasury.

Representatives of the mutual fund industry have pointed out that the competitive imbalance between the mutual funds and the life insurance that would be created by removing the company level tax could be removed if Revenue Ruling 81-225 were revoked or legislatively overruled. That revenue ruling basically says that you cannot wrap a variable annuity around a mutual fund and sell that on a tax deferred basis when it could not be sold without putting it in the guise of an annuity. But they point out that if you remove that restriction then the mutual funds could participate in the management of variable annuities by contracting with a life insurance company to market a variable annuity designed to invest in that mutual fund.

A revocation of that ruling would also eliminate a competitive imbalance that has arisen within the mutual industry itself because under that ruling investors may purchase an annuity that invests in a fund managed by the insurance company or managed by an affiliated company but the tax deferral under the annuity rules is not available if the insurance company invests in a fund managed by an unrelated investment adviser.

This is a competitive imbalance. We recognize it. And we certainly do not like the fact that tax laws create such competitive imbalance. But we must oppose the overruling of 81-225. We do so because the current tax treatment of annuities is far more favorable than the current tax treatment of comparable investments. And unless this favorable treatment were either eliminated or made available to all investments, some competitive imbalance necessarily results.

The cost of eliminating this imbalance by overruling 81-225 would be to greatly expand the use of wraparound annuities and a corresponding decrease in the volume of currently taxable investments in mutual funds. It would also tend, we think, to undermine the public's perception of the tax system if you can offer virtually the same mutual fund on a taxable and tax deferred basis at the taxpayers' election, with virtually no difference in the nature of the investment.

Our concerns, Mr. Chairman, are considerably less with respect to variable life insurance. And just to make it brief, because of the definition of life insurance contained in this bill, we would not oppose the amending of S. 1992 to extend the more favorable rules currently applicable to qualified plans to realize capital gains under variable life insurance policy.

Now let me switch to the policyholder loan provisions. The absence of a current tax on policyholders' inside build up is, of course, a significant benefit under present law. Assuming the statutory definition of life insurance is enacted as contained in the bill, that would preclude the use of overly invested oriented life insurance policies. We support the continuation of a longstanding tax preference for the inside buildup as a means of encouraging the purchase of whole life policies. We are seriously troubled however, with allowing a policyholder to borrow his accumulated cash value and deduct the interest payments thereon while the cash fund continues to build up tax free. If an unlimited interest deduction is allowed for borrowing against life insurance, the resulting tax arbitrage may encourage investment in life insurance exclusively for this arbitrage benefit. In fact, life insurance policies with systematic borrowing have been marketed as tax shelters by some of the major brokerage houses, as I think Henson Moore indicated, advertising writeoffs of four or five to one.

Let me illustrate the arbitrage that may be possible if you take a taxpayer who borrows at 11-percent interest rate against the cash value of a policy which is earning a rate of interest of 10 percent, and assume that taxpayer is in the 50-percent bracket so the after tax cost of his borrowing is 5½ percent. He will earn an after tax return of 4½ percent. The company earns a before tax return of 1 percent, the difference between the interest it receives of 11 percent and the interest it must credit to its policy of 10 percent.

While the funds are normally on deposit with the insurance company, in reality, they are available for the policyholders' unrestricted use. The allowance of a deduction for interest on loans undoubtedly encourages the purchase of life insurance. And for that reason, we think that the allowance of the deduction on policyholder loans of relatively small amounts or for short durations is desirable. But a whole life policy that involves systematic borrowing of the full cash value is an entirely different matter. The systematic borrowing is inconsistent with the fundamental reasons for allowing the tax preference on the inside build up on whole life insurance, that is, the encouragement of long term savings to life insurance. If there is a systematic borrowing, of course, no new saving is, in fact, occurring.

The benefit of unlimited deductibility of interest while earning tax free income is so substantial that it can make the after tax cost of purchasing a life insurance policy negative in the case of higher bracket taxpayers. In other words, the Federal Government is, in effect, paying the cost to buy permanent insurance and to borrow out the full cash value of the policy.

Take an example of a 45-year-old male buying a policy with an initial face amount of $10 million, but you can use any figure, $1 million or a $100,000. The policy is designed to meet the proposed definition of insurance contained in S. 1992—so it meets the definition of "insurance" under this bill, which is we think a reasonable and good definition. Using reasonable assumptions on interest rates, the policyholder will no longer incur any current out of pocket costs by the time he reaches age 56. He bought the policy at age 45 and he no longer will incur any current out of pocket costs at age 56. For each year thereafter, the policyholder will receive free term insurance coverage as well as a tax free amount of cash if he is in the 50-percent bracket. He will recoup his total out of pocket cost by the time he reaches age 63. And I have a table on page 11 in the testimony showing the cumulative out of pocket cost and the cumulative cost of insurance and loading expenses.

By the time he reaches age 75, his life expectancy, the Federal Government will have made grants to the policyholder of over $2.5 million of essentially free insurance protection plus over $5 million of net cash benefits.

The original proposal in the original bill on the House side on policyholder loans would have restricted the interest deduction to loans of up to $50,000. We supported that original limitation in our testimony on the House side in July of this past year.

In the bill now before you that original restriction is weakened in several respects. The most important one, of course, is the $50,000 is raised to $250,000 or $500,000 in the case of a joint return. There is an unlimited carryover so that if the full loan limit is not used in any year of the policy, that amount is carried over and may be added to the interest deductible on loans in future years. And then as Mr. Moore pointed out, in a business you multiply the $500,000 times the number of qualified lives covered in the policy so that the the restriction on the interest deduction, can be many times the $500,000 normal restriction.

Because of the unlimited carryover particularly, even applying the restriction on policy loans under this bill a 45-year-old married individual in the 50-percent tax bracket may purchase a life insurance policy with an initial death benefit of $500,000 and would not reach the limitation on interest deductibility until he reaches the age of 79, even though policy loans exceed $500,000 at 67 and have grown to almost $2 million by the time the carryover is exhausted.

As this example points out, the point at which the interest deduction limitation first applies is 4 years beyond the policyholder's life expectancy, and 16 years after he will recoup all of his out of pocket costs. Even if tax benefits are curtailed at that point, the benefits of the earlier years will be sufficient to allow the continued marketing of policies of this magnitude. Moreover, the policyholder may be able to continue the arbitrage if he is able to borrow from other sources without using the policy as collateral.

So, Mr. Chairman, we are supporting the limitation contained in S. 1992 as a reasonable step toward placing limits on the deductibility of interest on policyholder loans. While we have concerns about the $500,000, $250,000 limits we are not arguing for a reduction in those limits at this time. But we are concerned about the carryover feature, the unlimited carryover of the amount and the treatment of business policies where you multiply the $500,000 times the number of employees covered by insurance.

We think if dollar limits are adopted on policyholder loans that they should not be expanded indirectly by other features of the bill. In other words, we think the dollar limit should be applied independently to each insured individual and to each taxable year.

Let me just mention in passing, very quickly, on the section 79 provision we are basically supporting the provisions of this bill which would make the antidiscrimination provisions in group term life insurance apply in a meaningful way. We also support the provision that applies to the $50,000 cap on tax free group term insurance to retired employees as well as active employees. We see no reason why deferred compensation in the form of an insurance premium paid on behalf of retired employees should be exempt from tax when the basic distributions from qualified plans are fully subject to tax. The magnitude of this benefit can be quite large so we are supporting the bill in that regard.

And then finally, Mr. Chairman, let me just mention the tax nondeductible contribution to individual retirement accounts, the $1,750 the chairman discussed with Mr. Moore, we are not at this time supporting that provision principally because of the revenue impact and because in the budget we are supporting instead the expanded spousal IRA. It might be a good provision to allow nondeductible contributions, but at this time, at least, we are not going to support it.

Thank you, Mr. Chairman.

SENATOR CHAFEE. Thank you very much, Mr. Chapoton.

[The prepared statement of Secretary Chapoton follows:]

For Release Upon Delivery
Expected at 9:30 a.m. EST
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STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I would like to begin by thanking the Chairman for scheduling these hearings on the taxation of life insurance products and policyholders. The policyholder provisions of S. 1992 are extremely significant, and are responsive to serious problems that exist in connection with the current tax treatment of life insurance products. Although these proposals do not raise significant revenues initially, the changes will help preserve the tax base against serious erosion in later years. We welcome this opportunity to present the Administration's views on these matters.

My remarks today will focus on the definition of life insurance, the treatment of annuities, variable products, policyholder loans, group-term life insurance and nondeductible IRAs. At times I will refer to our July 28, 1983 testimony before the House Ways and Means Subcommittee on Select Revenue Measures on the original life insurance proposal. This proposal was modified and incorporated into H.R. 4170. The life insurance provisions of H.R. 4170 are substantially the same as S. 1992.

1. Definition of Life Insurance (Section 221 of S. 1992)

Background

A cash value life insurance policy involves two components: insurance and investment. The insurance component stems from the insurance company's agreement to pay to the named beneficiaries a specified amount if the insured dies while the policy is in force. The investment component arises from the fact that, during the early years of a policy, the policyholder pays a higher premium than is necessary to cover the current cost of insurance protection. The excess premiums accumulate for the benefit of the policyholder. This accumulated fund is generally referred to as the cash surrender value of the policy. The life insurance company credits an investment return to the cash surrender value in a manner similar to the interest which would be paid by a bank. This investment return is commonly referred to as "inside build-up." The cash surrender value of a policy, including accumulated interest, may be used to pay the cost of pure insurance protection if those charges exceed the current premium payments, and generally is available to the policyholder if the policy is surrendered. Also, as the cash surrender value grows, the amount of pure insurance protection decreases since the insurance company is at risk only for the excess of the face amount of the policy over the cash surrender value.

Under the Internal Revenue Code, a number of significant tax benefits are given to life insurance. The two most significant are: (1 the exclusion from gross income of death proceeds, and (2) the failure to impose any current tax on the "inside build-up."

Until fairly recently, virtually all life insurance policies fell into one of several traditional molds. Even some of these traditional policies had a significant degree of investment orientation that took advantage of the tax benefits of life insurance. In recent years, however, the degree of investment orientation in life insurance policies has increased. Higher interest rates and increased competition among insurance companies (and other financial intermediaries) has led to the development of a number of new life insurance products and modifications of traditional products. In some cases, policies were designed to maximize the ability of an investor to earn interest on a tax-free basis in a life insurance policy, with death protection being at most a secondary consideration. This development has created a need for a definition of life insurance to specify the types of policies that merit favorable tax treatment. Without such a limitation, life insurance would become simply a tax-exempt savings vehicle.

The most visible of the new products has been universal life insurance. While this flexible-premium product has been sold in many cases for reasons completely unrelated to taxes, in some instances tax savings was clearly the dominant concern. For example, some policies were sold that permitted policyholders to select as little as $10,000 or less of pure insurance protection, while the cash value on the policy might be $100,000 initially, and increase thereafter. In such cases, these so-called "life insurance" policies amounted to little more than a minimal amount of term insurance protection coupled with tax-deferred savings accounts for the benefit of the policyholder, with a conversion of the tax deferral to total tax exemption at the policyholder's death.

TEFRA Definition

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act ("TEFRA"), there was substantial doubt whether universal life insurance should be treated as life insurance for tax purposes. In addition, there was concern that universal life insurance could be used to produce unduly investment-oriented forms of life insurance. To reconcile the legitimate uses of flexible premium life insurance with the need to place some limitation on the tax avoidance potential of this new product, Congress enacted section 101(f) of the Internal Revenue Code as part of TEFRA. This section provided that universal life insurance would be treated as life insurance for tax purposes if certain conditions were satisfied. The definition was made effective only for policies issued prior to January 1, 1984.

The basic approach of the temporary, TEFRA definition was to limit the investment orientation of these policies by requiring that, in order to qualify as life insurance for tax purposes, a flexible premium policy would have to provide at least specified amounts of insurance protection, depending on the cash value in the policy and the age of the policyholder. Two alternative methods of satisfying this statutory test were provided:

Alternative 1 -- Premiums could not be paid in more rapidly than the "guideline premiums," and a minimum ratio of death benefit to cash value had to be maintained. This minimum ratio, known as the "corridor", is 140 percent until the policyholder reaches age 40 and declines by 1 percent each year until the policyholder reaches age 75.

Alternative 2 -- The cash value at any time during the life of the contract could not exceed the net single premium for that policy at that time.

Proposed Change

The definition of life insurance contained in S. 1992 would make several significant modifications to the TEFRA definition of life insurance. The most significant changes are:

- The proposed definition would apply to all life insurance policies, not merely flexible premium policies.
- A requirement has been added that the policy cannot endow until the insured reaches age 95. (A policy endows when the cash surrender values grows to equal the death benefit.)

- The cash value "corridor" has been made more strict. Until the policyholder reaches age 40, the death benefit/cash value ratio must be at least 250 percent. This figure declines in an irregular manner to 105 percent when the policyholder reaches age 75, and declines again from ages 90 to 95 in order to allow the policy to endow.
- The provision which allows a policy designed to provide a level or declining amount at risk rather than a level death benefit (i.e., each dollar increase in cash value produces an equal or smaller increase in death benefit) has been limited to level premium policies.

In general, the Administration believes that the proposed definition of life insurance contained in S. 1992 provides an acceptable limitation on the investment orientation of life insurance. Hence, we support this provision of S. 1992 and we strongly urge that it not be deleted from the bill or weakened.

We would note, however, that certain features of the original proposal have not been retained in S. 1992 or H.R. 4170. In particular, the requirement that premiums be paid no more rapidly than under a policy calling for 10 equal payments has been eliminated and the proposed corridor test has been loosened. As a result of these changes, the permitted degree of investment orientation has been increased. While we are not urging changes in the rules in S. 1992, we strongly believe that no further relaxing of these standards should be undertaken.

Examples

As we have previously testified, one measure of the investment orientation of a life insurance contract is the ratio of the aggregate investment income to cumulative mortality and loading charges, measured at a time when the policy might be expected to terminate (age 70). We refer to this as the "investment/insurance" ratio. A traditional whole life policy will typically have an investment/insurance ratio of approximately 1:1.

In our earlier testimony, we described a policy which could be sold to a 35-year-old individual that was one of the more investment-oriented policies permitted under the TEFRA definition of life insurance. Under certain reasonable assumptions regarding interest rates over the life of the policy, this policy produced an investment/insurance ratio of almost 9:1. Under the same interest rate assumptions, but using the original proposed definition of insurance, the investment/insurance ratio would have been reduced by almost half to 4.6:1, primarily because of the 10-pay limitation. The changes in the corridor percentages standing alone, have a relatively small impact since the largest changes in the corridor percentages occur in the early years of the policy, when the corridor test is not likely to apply.

Under the definition proposed in S. 1992, the investment/insurance ratio would still be more than 8:1. Although this is somewhat lower than under the TEFRA definition, it does not reflect a major change to the standards. Other aspects of the definition, such as the requirement that the policy not endow before age 95, are of greater significance, and would not treat as life insurance for tax purposes policies that are even more investment oriented than the policy described above.

Transition Issues

The proposed effective date for the definition of life insurance contained in S. 1992 is January 1, 1984. The Administration fully supports the retention of this effective date in order to prevent the sale of abusive, investment-oriented policies from receiving favorable tax treatment. We recognize, however, that certain policies which are not among the most abusive do not meet the requirements of the proposed definition. However, these policies contain certain provisions that can be used in the design of abusive products. Most, but not all, of the nonabusive policies that contain potentially abusive provisions are given a one-year period during which they would not be required to comply with the new statutory requirements and during which the affected companies could redesign their policies to comply with the new definition. We would be happy to work with the Committee and representatives of the life insurance industry to identify those policies not currently covered by the transition rule but which merit some form of transition relief.

2. Distributions Under Annuity Contracts (Section 222)

Background

A deferred annuity contract is a form of savings contract issued by life insurance companies. The annuity purchaser deposits funds with an insurance company and, as in the case of a bank account, the insurance company holds the purchaser's money and credits interest thereon. The amounts deposited and interest accumulated may be paid eventually to the policyholder in a lump sum or in a series of annuity payments. The principal tax benefit afforded to such a deferred annuity contract is that no tax is imposed currently on the interest income credited.

Under current law, if the purchaser of a single premium annuity withdraws funds within 10 years of the time the annuity was purchased and before reaching the age of 59-1/2, a penalty is imposed equal to 5 percent of the amount included in gross income as a result of the premature distribution. There is no limit on the period for which tax deferral may continue under an annuity contract.

Proposed Changes

Section 222(a) of S. 1992 would, in effect, remove the 10-year alternative, so that any distribution under an annuity contract before the policyholder reaches the age of 59-1/2 would be subject to the 5-percent penalty. We believe that this proposed change is appropriate and should be retained. Tax on the interest income earned under an annuity contract is deferred until the contract is surrendered. This is very favorable tax treatment when compared to current taxation of most investment income. This preferential treatment of annuities has been justified on the basis that these annuities are used as vehicles to provide for retirement savings. We do not believe that this purpose is served if amounts are withdrawn prior to retirement. For this reason, it is appropriate to require an annuity purchaser to keep funds invested until age 59-1/2 in order to receive the full benefit of tax deferral.

The 5-percent penalty is not overly harsh and certainly does not preclude withdrawals before age 59-1/2. In fact, even with this penalty, a policyholder who withdraws income from a deferred annuity after as little as 5 years frequently will have more income after the tax and penalty than a taxpayer who had left those funds in an investment that was subject to tax currently.

S. 1992 also contains a rule that if the holder of an annuity contract dies before the annuity starting date, the cash value of the contract will be included in the taxable income of the holder for the year in which his death occurs. It is our understanding that this rule became a part of the current life insurance tax package as a substitute for a rule in the original proposal which would have required distributions under an annuity contract to begin at age 70-1/2.

It would appear that both the original proposal and the rule contained in S. 1992 are premised on the notion that the tax deferral under an annuity contract ought not to be permitted to continue for too long a period. While we would agree with this general premise, we believe that the rule in S. 1992 is overly restrictive. In our view, whatever justification exists for deferral under an annuity contract continues as long as the policyholder or his spouse is alive, but ceases at the death of the survivor. Hence, we would support a rule requiring distributions to begin at the death of the survivor and to be completed within a relatively short period. Again, we would be happy to work with the Committee in this area.

3. Variable Life Insurance and Variable Annuities (Proposed Section 817 of the Code)

Background

Variable life insurance and annuities are modifications of the traditional forms of life insurance and deferred annuities. The principal difference between the traditional and variable products lies in the manner in which the investment return in the contract is credited to the policyholder. Under traditional products, the life insurance company credits interest to the policyholder on his cash surrender value at a rate fixed in the contract. By comparison, in a variable product the life insurance company puts the policyholder's cash value in a separate fund which may be invested in stocks or various fixed-income securities. The amount credited to the policyholder's cash value reflects the investment performance of the underlying fund.

Variable products are a relatively recent development. Variable annuities were developed in the 1950s, primarily as a vehicle to enable teachers to invest their retirement funds in common stocks, instead of being limited to fixed income securities. Variable life insurance was developed in the 1970s to encourage equity investors to invest in life insurance.

Current law contains explicit rules governing the taxation of variable annuity contracts. In general, these rules are designed to allow the life insurance company a full deduction for the amount of ordinary income credited to the policyholders (even though the policyholder pays no current tax on such income since it constitutes "inside build-up"). However, realized capital gains allocable to the policyholders' fund (other than funds allocable to qualified pension plan contracts) are taxable in full to the life insurance company.

One effect of these rules is that life insurance companies are able to sell deferred annuities that are little more than money market accounts, the income from which is effectively tax deferred. The rules also have led to the development of so-called "wraparound" annuities. Under this latter type of arrangement, a taxpayer could make an investment through a life insurance company virtually identical to one that could be made by the taxpayer directly. No current tax would be imposed on either the company or the individual taxpayer if the investment were made through an insurance company while full current taxation to the investor would result if the investment were made directly.

In response to these wraparound annuities, the Internal Revenue Service issued several revenue rulings holding that the investors owned the underlying investments rather than an annuity. The annuity portion of the contract was properly characterized as without substance. One of these rulings, Rev. Rul. 81-225, held that an annuity that invests in shares of publicly available mutual funds will be disregarded, and that the investor will be treated as the owner of the mutual fund share. As a consequence, the investor was taxable currently on the investment income allocable to those shares.

Another effect of the existing tax rules is that life insurance companies are effectively precluded from selling variable annuities that invest primarily in assets producing capital gains (except in the context of qualified plans). This results from the fact that a current capital gains tax is imposed on the life insurance company on realized capital gains and a tax is imposed on the policyholder at ordinary income rates when the net gain is ultimately withdrawn from the annuity.

By comparison, existing law does not contain explicit rules governing the tax treatment of variable life insurance, and the proper method of applying the generally applicable rules to the variable products has been unclear.

Discussion

S. 1992 contains a special provision for variable contracts that would apply to both variable annuities and variable life insurance. In effect, this provision retains the existing rule applicable to variable annuities and extends it to variable life insurance: a capital gains tax is imposed on the company on capital gains realized by the fund underlying the variable contracts. In addition, a second tax is imposed on the capital gain (at ordinary income rates) at the policyholder level when distributions are made under a variable annuity contract. This tax also is imposed if a variable life insurance contract is surrendered prior to the policyholder's death, but only on the excess of the cash surrender value over the aggregate gross premiums paid under the contract.

Sellers of variable life insurance have argued that the rules described above discriminate against their products to such an extent that sale of these products would be effectively foreclosed. Also, those wishing to sell capital-gains oriented variable annuities argue that the current discrimination against this type of investment vehicle is unfair. Both groups have requested that the provision described above be removed from S. 1992.

The Administration would not support the elimination of the corporate level capital gains tax imposed under S. 1992 in connection with variable annuities. While life insurance companies traditionally have sold fixed-income investments on a tax-preferred basis, both through life insurance and annuities, they have not sold capital-gains oriented investments through variable annuities. In this period of increased financial deregulation and increased competition between financial intermediaries, we see no basis for expanding the range of tax-favored investments that the life insurance industry may sell. A change in the current treatment of variable annuities could significantly shift the competitive balance among various types of financial intermediaries in favor of life insurance companies and cause significant revenue losses to the Treasury.

Representatives of the mutual fund industry have pointed out that the competitive imbalance between the mutual fund and life insurance industries that would be created by removing the company-level capital gains tax on variable products could be cured or substantially reduced if Revenue Ruling 81-225 were revoked or legislatively overruled. This would allow any mutual fund to participate in the management of variable annuities by contracting with a life insurance company to market a variable annuity designed to invest in that fund.

Revocation of Rev. Rul. 81-225 would also eliminate a competitive imbalance that has arisen within the mutual fund industry following the publication of that ruling. Under that ruling, investors may purchase an annuity that invests in a fund managed by the insurance company or an affiliated corporation (which fund could be substantially similar to a publicly traded fund sold through that or another affiliate), but not an annuity that invests in a fund managed by an unrelated investment adviser.

While we would agree generally that the tax laws should not create competitive imbalances, we would oppose the legislative overruling of Rev. Rul. 81-225. The current tax treatment of annuities is far more favorable than the tax treatment of comparable investments. Unless this favorable treatment were either eliminated or made available for all investments, some competitive imbalance necessarily results. The cost of eliminating this imbalance, insofar as it relates to mutual funds, would be a greatly expanded use of wraparound annuities and a corresponding decrease in the volume of currently taxable investments in mutual funds. It would also tend to undermine the public's perception of the tax system if essentially the same mutual fund were offered on a taxable and a tax-deferred basis, at the taxpayer's election, with virtually no difference in the nature of the investment.

Our concerns with variable annuities are considerably less significant when applied to variable life insurance. Unlike a variable annuity, a variable life insurance policy is not purely an investment vehicle, particularly in light of the limitations which will be imposed by the new definition of life insurance. Accordingly, direct competition between variable life insurance and mutual funds is a much smaller problem. Moreover, variable life insurance is an important product currently being marketed by several large companies. This is possible because the current variable annuity rules, which impose a corporate-level tax on realized capital gains, are not applicable to variable life insurance.

In light of the above considerations, we would not oppose amendments to S. 1992 which would continue the existing treatment of variable annuities, but would extend the more favorable rules currently applicable to qualified plans to realized capital gains under a variable life insurance policy. However, when a variable policyholder realizes gains upon the switch of his funds from one investment option to another within the policy, we believe it would be appropriate to impose a capital gains tax at this time.

4. Policyholder Loans (Section 223)

Background

As noted above, one of the most significant tax benefits given to life insurance is the absence of any current tax on policyholders' inside build-up. This exemption from current taxation is a "tax preference" in the sense that it does not subject to tax income that would be taxed if an equivalent investment were made through a bank rather than a life insurance company. Under the doctrine of constructive receipt, a life insurance policyholder would be taxable currently on the inside build-up since this income generally may be drawn upon without substantial limitation or restriction.

Assuming that a statutory definition of life insurance is enacted that would preclude the use of overly investment-oriented life insurance policies, we support the continuation of this long-standing tax preference as a means of encouraging the purchase of whole life insurance. We are seriously troubled, however, with allowing a policyholder to borrow his accumulated cash value and to deduct the interest payments thereon while the cash fund continues to build up free of tax. If an unlimited interest deduction is allowed for borrowing against a life insurance policy, the resulting tax arbitrage may encourage investment in life insurance exclusively for this arbitrage benefit. In fact, life insurance policies that employ systematic borrowing of cash value have been marketed as tax shelters by some of the major brokerage houses, advertising 4:1 and 5:1 tax write-offs without any investment risk.

This potential for arbitrage may be illustrated by considering a taxpayer who borrows at an 11 percent interest rate against the cash value of a policy which earns interest at a rate of 10 percent. Assuming that the taxpayer is in the 50-percent tax bracket, his after-tax cost of borrowing is reduced to 5.5 percent so that he will earn an after-tax return of 4.5 percent. The company earns a before-tax spread of 1 percent. Moreover, while the policyholder's funds are nominally on deposit with the life insurance company, in reality they are available for the policyholder's unrestricted use.

The allowance of a deduction for interest paid on policyholder loans undoubtedly encourages the purchase of life insurance and, for that reason, allowance of an interest deduction on policyholder loans of relatively small amounts or for short terms may be desirable. A whole life policy in which substantially all the cash is systematically borrowed, however, is a different matter. Such a policy differs little from a renewable term policy.

Allowing a deduction for interest incurred on systematic borrowing against a life insurance policy is also inconsistent with one of the fundamental reasons for allowing a tax preference for whole life insurance: the encouragement of long-term savings through life insurance. If the cash value of a life insurance policy is systematically borrowed, no new savings occurs. Hence, the justification for the failure to tax inside build-up currently disappears.

Permitting a deduction for interest paid on policyholder loans also is inconsistent with general limitations in the Code on the deductibility of interest incurred in other arrangements where similar tax arbitrage could be realized. For example, section 163(d) imposes a limit on the amount of interest that may be deducted in connection with indebtedness incurred to purchase or carry investment property. Similarly, section 265(2) denies a deduction for interest on a loan incurred to purchase or carry tax-exempt securities.

The benefit of unlimited deductibility of interest while earning tax-free income is so substantial that it can make the after-tax cost of purchasing a life insurance policy negative for high-bracket taxpayers. In other words, the Federal Government will in effect pay people to buy permanent insurance and borrow out all of the cash value. The larger the face amount of the policy, the more the Federal Government will pay the policyholder.

As an example of the benefits of the arbitrage described above, consider a policy for a 45-year-old male with an initial face amount of $10 million. Even if the policy is designed to meet the proposed definition of insurance in S. 1992, under reasonable assumptions regarding interest rates, the policyholder will no longer incur any current out-of-pocket costs by the time he reaches age 56. For each year thereafter, the policyholder will receive free term insurance coverage, as well as a tax-free amount of cash if he is in the 50-percent tax bracket. Moreover, he will recoup his total out-of-pocket costs by the time he reaches age 63. The total out-of-pocket costs and the cumulative cost of insurance and loading expenses are indicated in the following summary table:

Age	Cumulative Net Out-of-Pocket Expense	Cumulative Cost of Insurance Protection*
50	$ 803,125	$ 468,267
55	474,138	869,517
60	263,525	1,301,730
65	(630,226)	1,625,288
70	(2,441,634)	1,994,162
75	(5,572,826)	2,563,647

Hence, by the time the policyholder reaches age 75 (his life expectancy), the Federal Government will have made grants to the policyholder of over $2.5 million of essentially free insurance protection plus over $5 million of net cash benefits.**

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*If purchased separately, the cost of the insurance protection would vary somewhat due to differences in loading and mortality charges.

**Further details on this example are contained in Exhibit 1, attached.

The original limitation proposed on the deductibility of interest with respect to a life insurance loan provided that the amount of interest which any taxpayer could deduct with respect to a loan under a life insurance policy, secured by a life insurance policy, or incurred or continued to purchase or carry such a policy, would be limited to interest on a loan principal amount of $50,000. Treasury supported this proposed limitation in our July 28, 1983 testimony.

Proposed Change

The limitation on the interest deduction for policyholder loans in S. 1992 is considerably weaker than that contained in the original proposal in a number of respects:

- For individual taxpayers, the $50,000 limitation amount has been increased to $250,000 ($500,000 in the case of a joint return).
- For an entity engaged in a trade or business, the dollar limitation is equal to $500,000 times the number of "qualified lives." A qualified life is any individual for whom the entity owns a life insurance policy (other than term insurance) and for whom the face amount of the policy is not less than 10 percent of the highest face amount of any policy carried by the entity on the life of any employee.
- If in any year the interest limitation exceeds the amount of interest deducted with respect to that taxpayer, the excess becomes a carryover to all succeeding years, without expiration. This means that the unused interest limitation in the early years of a policy when the policy loan amount is relatively small, may be accumulated for use in later years when the policy loan amount is larger.
- The limitation of S. 1992 would apply only to loans against policies issued after September 27, 1983. The original limitation would have applied to all loans after August 2, 1983, regardless of when the policy was issued.

Examples of Tax Arbitrage Permitted Under the Limitations of S. 1992

Primarily because of the unlimited carryover of unused limitation amounts, it is still possible for life insurance companies to design and sell very large policies which are based on a systematic plan of policy loans and tax arbitrage. For example, under the definition of life insurance contained in S. 1992, a 45-year-old married individual in the 50-percent tax bracket may purchase a life insurance policy with an initial death benefit of $500,000 which, under reasonable assumptions, does not reach the limitation on interest deductibility until the policyholder reaches the age of 79, even though the policy loan exceeds $500,000 at age

67 and has grown to almost $2 million by the time the carryover is exhausted.*

In this example, the point at which the interest deduction limitation first applies is four years beyond the policyholder's life expectancy and 16 years after he will have recouped all of his out-of-pocket costs. Even if tax benefits are curtailed at that point, the benefits in the early years will be sufficient to allow the continued marketing of policies of this magnitude. Moreover, the policyholder may be able to continue the arbitrage if he is able to borrow from other sources (without using the policy as collateral).

For a top executive of a company engaged in a trade or business, even larger policies are possible, provided the company is willing to provide policies for other employees with a face amount equal to at least 10 percent of the face amount of the largest policy. For example, a company might be able to maintain and systematically borrow out all available cash on a policy of $2.5 million on its chairman and policies of $250,000 on each of nine other employees. Where such additional employees are covered, they are treated as "qualified lives" and hence the interest limitation increases even if the policies covering the other employees have little or no cash value that may be borrowed. While the details of the maximum arbitrage obtainable will vary depending on the ages of the various officers, the length of time that the policies have been in effect, assumptions as to future interest rates, and other factors, the ability to share the interest limitation among several qualified lives will generally offer a significant potential for additional arbitrage on the policy for the top employee.

Discussion

The Administration supports section 223 of S. 1992 as a reasonable step toward placing limits on the deductibility of interest on policyholder loans. While this provision does not eliminate the possibilities for substantial tax arbitrage in this area, the largest abuses should be eliminated under this provision. Although we did support a lower dollar limitation in our earlier testimony, we are not arguing for a reduction in the $250,000 and $500,000 amounts at this time.

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* Further details on this example are contained in Exhibit 2, attached.

We are concerned, however, that certain features of the proposed bill indirectly expand the dollar limitations so that multimillion dollar loans are possible. As the example above illustrates, the unlimited carryover of unused interest limitations allows the policy loan amount to grow to almost $2 million before the interest limitation takes effect. The provision relating to qualified lives has a virtually unlimited potential for expanding the policy loan dollar limits in the business context.

If this Committee accepts the dollar limits contained in S. 1992, it would seem that these limits should not be expanded indirectly by other features of the bill. In order to prevent such an expansion, the dollar limits should be applied independently to each insured individual and to each taxable year. Hence, we believe that the unlimited carryover of unused interest limitation should be replaced with a more limited provision allowing policy loan interest for which a deduction is disallowed to be treated as policy loan interest paid in the succeeding taxable year (and all future taxable years until deductible). This parallels the treatment of disallowed investment interest expense under section 163(d) of the Code.

We also believe that the provision allowing a business entity to calculate its policy loan deduction limitation based on the number of qualified lives should be amended so that the limitation applies independently to each qualified life. In this way, employers will not be able to artificially inflate the amount of permitted tax arbitrage.

5. Group-Term Life Insurance (Section 224)

Background

Section 79 of the Internal Revenue Code provides that when an employer provides group-term life insurance coverage, the cost of the first $50,000 of coverage is excluded from the gross income of the employee and the cost of any additional coverage is determined on the basis of a uniform premium table prescribed by regulations and using 5-year age brackets. In the case of group-term insurance provided for disabled and retired employees, the cost of the entire amount of insurance coverage provided by the employer is excluded from gross income.

In 1982, it was brought to the attention of Congress that the special benefits given to group-term life insurance afforded certain employers a way to provide deferred compensation benefits to officers and highly compensated individuals that avoided the nondiscrimination requirements applicable to qualified pension plans, but which enjoyed all of the tax benefits available under qualified plans. Since life insurance benefits serve, in effect, as a supplement to retirement benefits, companies wishing to provide additional retirement benefits to key employees on a discriminatory basis could do so through the use of group-term insurance.

Congress responded in TEFRA by adding section 79(d) to the Code. This section provides that if a group-term life insurance plan is discriminatory in favor of key employees, the cost of the first $50,000 of coverage provided for key employees would not be excluded from gross income.

Proposed Changes

The amendment made by TEFRA was deficient in two respects. First, the sanction for violating the nondiscrimination requirements is so weak that discriminatory plans still provide significant tax benefits in many instances. In cases where large amounts of coverage are involved, the principal benefit of section 79 is often not the exclusion from gross income of the cost of the first $50,000 of coverage, but rather the right to calculate the cost of the remaining coverage, on the basis of the uniform premium table.

This advantage stems from the fact that the uniform table is designed to approximate the average cost of $1,000 of insurance for all employees in the given 5-year age bracket. Hence, employees in smaller groups (where loading charges are generally higher than average) and employees in ill health may include in gross income an amount which can be significantly less than the actual cost of the insurance protection provided. For these employees, there is still a strong incentive to provide large amounts of group-term coverage on a discriminatory basis to obtain the benefits of the uniform table.

Second, and more significantly, the current exclusion of the cost of an unlimited amount of term insurance for retired employees is unjustified, and should be substantially changed. Term life insurance generally serves to provide protection against the premature death of an income earner. If a premature death occurs, the insurance proceeds can be used to provide the family with a source of income that will replace the wages that the deceased breadwinner would have earned.

After a wage earner retires, the need for this type of life insurance protection virtually never increases and, in fact generally decreases. After retirement, an employee's salary is replaced by pension benefits and social security. To some extent, these benefits continue to be provided to the surviving spouse of a retired employee. For this reason, there is generally less need for term insurance protection after retirement than before retirement. Consequently, there is no need to tax employer-provided group-term insurance more favorably than pre-retirement life insurance benefits.

We see no reason why deferred compensation in the form of term insurance premiums paid on behalf of retired employees should be exempt from tax when the basic distributions from qualified plans are fully subject to tax. We also believe that the current rules enable employers to avoid several restrictions and requirements applicable to other tax-favored forms of deferred compensation. For example, defined benefit pension plans generally may not provide annual benefits in excess of $90,000 per year. If a group-term life insurance plan is established to supplement this type of pension plan, this limitation may be easily avoided.

The magnitude of the benefits under these plans of plan can be quite substantial: coverage for retired executives of $1 million or more is becoming increasingly common. The cost of a $1 million policy for a 65-year-old retired employee would cost approximately $25,000 a year. The annual cost would increase to $40,000 a year by age 70 and to $100,000 by age 80.* As is apparent, these plans provide substantial benefits that should not be ignored.

Finally, under present law, the nondiscrimination rules contained in section 79 do not apply to the tax benefits provided to retired employees. By comparison, the substantial tax benefits available under deferred compensation arrangements under qualified pension and profit-sharing plans are largely eliminated if the plan discriminates in favor of highly compensated employees. Since both types of arrangements provide tax-favored treatment for comparable deferred compensation arrangements, they should be subject to comparable nondiscrimination rules.

Discussion

Section 224 of S. 1992 would address both of the concerns discussed above. In the case of a group-term life insurance plan which discriminates in favor of key employees, the actual cost of the entire amount of coverage (other than the amount paid by the employee) would be included in the employee's gross income. In other words, the benefit of the use of the uniform premium table would be denied, as would the benefit of the exclusion for the first $50,000 of coverage. It is anticipated that, in most cases, this rule will be sufficient to discourage employers from providing group-term coverage on a discriminatory basis so that no computation of actual cost will be necessary. In those few remaining discriminatory plans, the determination of the actual cost of insurance should not be unduly complicated given modern computer capabilities.

The bill also would delete the special exclusion from gross income of the cost of group-term insurance provided to retired employees. (Disabled employees would not be affected and retired employees would still be allowed to exclude the cost of the first $50,000 of employer-provided coverage.) In addition, retired employees would be subject to the same nondiscrimination requirements as active employees.

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* These cost figures reflect the mortality charges based on the 1980 Commissioners' Standard Ordinary Mortality Table. The actual cost will depend on many different factors.

The Administration supports both of these proposed changes and urges the Committee not to delete them from the bill. If the nondiscrimination requirement imposed by TEFRA is to be meaningful, it is essential that the consequences of discrimination extend to the loss of all benefits provided by section 79, including those of the uniform premium table, and that the rule apply to all key employees, whether active or retired. We also support the elimination of the total exclusion from gross income of the cost of group-term insurance provided to retired employees that is contained in section 224 of S. 1992. This would assure that payment of term insurance premiums would be taxed no more favorably than other forms of retirement benefits, and that group-term insurance would not afford an easy opportunity to exceed the dollar limits applicable to qualified plans.

Some have suggested that a preferable alternative to this rule would be simply to extend the nondiscrimination requirements of section 79(d) to retired employees. We do not believe that this change alone would be sufficient. As has been stated, we do not believe employers should be allowed to avoid the dollar limits and other restrictions applicable to qualified plans through the establishment of a plan providing group-term life insurance. Moreover, unless group-term life insurance plans were subject to vesting and funding requirements similar to those applicable to qualified plans, in many instances meaningful post-retirement benefits would be available only for key employees.

Transition Rule

Section 224 of S. 1992 contains a transition rule which exempts from the changes described above all employees covered under group-term life insurance plans in existence on September 27, 1983, up to the amount of that individual's coverage on that date. Since active and retired employees may have entered into group-term life insurance plans in reliance on the tax law now in effect, and since other decisions relating to retirement plans may have been affected as well, we believe that this generous transition rule is appropriate. Moreover, we would be glad to work with the Committee to refine this transition rule, if necessary, to ensure that the rule will not inhibit normal business practices concerning the selection of an insurance company to provide the insurance protection.

6. Nondeductible IRA Contributions

S. 1992 also contains a provision allowing nondeductible IRA contributions of up to $1,750 per year for each individual. While the Administration fully supports properly structured incentives to increase individual savings, we cannot support this feature of the bill.

Whatever the merits of this proposal, we are concerned about the revenue loss which would arise if the nondeductible IRA provision were adopted. Over time, the revenue loss attributable to nondeductible IRA contributions would grow rapidly because the pool of contributions, interest, dividends, and other gains would compound on a tax-deferred basis. Our revenue estimates for the nondeductible IRA proposal in S. 1992 are as follows:

1984	1985	1986	1987	1988	1989
		(millions)			
-$15	-$66	-$141	-$227	-$321	-$423

This concludes my prepared remarks. I will be happy to answer any questions the Chairman and other members of the Committee might have.

Exhibit 1

PLAN OF BORROWING AS PART OF $10 MILLION WHOLE-LIFE POLICY MEETING THE DEFINITION OF LIFE INSURANCE UNDER S. 1992

AGE	ANNUAL POLICY LOAN	ANNUAL LOAN INTEREST	CUMULATIVE LOAN INTEREST	NET OUT OF POCKET EXPENSE (AFTER TAXES)	CUMULATIVE NET OUT OF POCKET EXPENSE	CUMULATIVE MORTALITY & LOADING CHARGES
45	$ 0	$ 0	$ 0	$ 219,433	$ 219,433	$ 132,879
46	219,433	24,137	24,137	12,068	231,502	202,818
47	219,433	48,275	72,413	24,137	255,639	264,720
48	219,433	72,413	144,825	36,206	291,846	329,510
49	0	72,413	217,238	255,639	547,486	397,378
50	0	72,413	289,651	255,639	803,125	468,267
51	0	72,413	362,064	255,639	105,765	542.585
52	937,993	175,592	537,657	-630,764	428,001	620,450
53	297,485	208,315	745,972	26,105	454,107	702,027
54	323,436	243,893	989,866	17,944	472,051	747,402
55	359,039	283,388	1,273,254	2,087	474,138	869,517
56	392,087	326,517	1,599,772	-9,395	464,743	954,489
57	429,416	373,753	1,973,525	-23,106	441,636	1,041,339
58	471,503	425,618	2,399,144	-39,261	402,375	1,129,045
59	519,086	482,718	2,881,863	-58,294	344,081	1,216,318
60	572,855	545,732	3,427,596	-80,556	263,525	1,301,730
61	633,903	615,462	4,043,058	-106,739	156,786	1,383,380
62	703,526	692,849	4,735,907	-137,668	19,118	1,458,798
63	783,457	779,030	5,514,938	-174,508	-155,390	1,524,638
64	876,004	875,390	6,390,328	-218,875	-374,266	1,576,276
65	966,231	981,676	7,372,004	-255,959	-630,226	1,625,288
66	1,057,392	1,097,989	8,469,994	-288,964	-919,190	1,679,762
67	1,154,471	1,224,981	9,694,975	-322,547	-1,241,737	1,742,896
68	1,260,351	1,363,619	11,058,595	-359,107	-1,600,845	1,815,598
69	1,375,774	1,514,954	12,573,549	-398,864	-1,999,709	1,898,911
70	1,501,413	1,680,110	14,253,660	-441,924	-2,441,634	1,994,162
71	1,638,088	1,860,300	16,113,960	-488,505	-2,930,139	2,102,880
72	1,795,984	2,057,858	18,171,818	-547,621	-3,477,761	2,217,511
73	1,971,994	2,274,777	20,446,596	-615,172	-4,092,933	2,335,730
74	2,169,818	2,513,457	22,960,054	-693,655	-4,786,589	2,453,325
75	2,394,072	2,776,805	25,736,860	-786,236	-5,572,826	2,563,647
76	2,650,376	3,068,347	28,805,207	-896,769	-6,469,596	2,657,073
77	2,894.218	3,386,711	32,191,919	-981,429	-7,451,026	2,771,694
78	3,1[illegible]83	3,374,144	35,926,063	-1,071,978	-8,523,004	2,911,472
79	3,4[illegible]37	4,113,010	40,039,074	-1,168,298	-9,691,302	3,081,345
80	3,751,945	4,525,724	44,564,798	-1,269,649	-10,960,952	3,287,933
81	4,082,735	4,974,825	49,539,624	-1,375,889	-12,336,841	3,538,927
82	4,435,789	5,462,762	55,002,386	-1,484,974	-13,821,816	3,845,139
83	4,810,961	5,991,968	60,994,354	-1,595,543	-15,417,360	4,219,759
84	5,208,637	6,564,918	67,559,273	-1,706,744	-17,124,104	4,677,799
85	5,629,275	7,184,138	74,743,411	-1,817,773	-18,941,877	5,236,064
86	6,073,477	7,852,220	82,595,632	-1,927,933	-20,869,811	5,913,056
87	6,541,285	8,571,762	91,167,394	-2,035,970	-22,905,782	6,729,586
88	7,032,297	9,345,315	100,512,709	-2,140,206	-25,045,988	7,770,234
89	7,545,140	10,175,280	110,687,990	-2,238,066	-27,284,056	8,879,268
90	8,076,769	11,063,725	121,751,715	-2,325,473	-29,609,529	10,272,186
91	8,621,670	12,012,108	133,763,824	-2,396,182	-32,005,711	11,927,881
92	9,576,929	13,065,571	146,829,395	-2,824,710	-34,830,422	13,490,483
93	10,707,921	14,243,442	161,072,838	-3,366,766	-38,197,189	14,879,787
94	12,056,832	15,569,694	176,642,532	-4,052,552	-42,249,741	15,990,972
95	13,708,483	17,077,627	193,720,159	-4,950,236	-47,199,978	16,656,189

Office of the Secretary of the Treasury
Office of Tax Analysis

January 31, 1984

Assumptions

1. Whole-life policy with initial face amount of $10,000,000 endowing at age 95 with annual premium of $219,433.
2. Contract pricing terms are 4 percent interest rate, 1980 CSO mortality rate table, and loading charges of 40 percent of gross premium in first year, 10 percent in second year, 5 percent in third through tenth year, and 2 percent thereafter.
3. Interest actually credited equals 10 percent.
4. Borrowing rate on the policy loan equals 11 percent.
5. Marginal tax rate of the policyholder equals 50 percent.
6. Definition of life insurance "corridor" proposed in S. 1992.
7. Borrows premium amount in only three of the first seven years, thereafter borrows all available cash value.

Exhibit 2

PLAN OF BORROWING AS PART OF $500,000 WHOLE-LIFE POLICY MEETING THE DEFINITION OF LIFE INSURANCE UNDER S. 1992

AGE	ANNUAL POLICY LOAN	ANNUAL LOAN INTEREST	CUMULATIVE LOAN INTEREST	CUMULATIVE INTEREST ALLOWANCE	NET OUT OF POCKET EXPENSE (AFTER TAXES)	CUMULATIVE NET OUT OF POCKET EXPENSE	CUMULATIVE MORTALITY & LOADING CHARGES
45	$ 0	$ 0	$ 0	$ 55,000	$ 0,971	$ 10,971	$ 6,643
46	10,971	1,206	1,206	110,000	603	11,575	10,140
47	10,971	2,413	3,620	165,000	126	12,781	13,236
48	10,971	3,620	7,241	220,000	1,810	14,592	16,475
49	0	3,620	10,861	275,000	12,781	27,374	19,868
50	0	3,620	14,482	330,000	12,781	40,156	23,413
51	0	3,620	18,103	385,000	12,781	52,938	27,129
52	46,899	8,779	26,882	440,000	31,538	21,400	31,022
53	14,874	10,415	37,298	495,000	1,305	22,705	35,101
54	16,171	12,194	49,493	550,000	897	23,602	39,370
55	17,951	14,169	63,662	605,000	104	23,706	43,475
56	19,604	16,325	79,988	660,000	-469	23,237	47,724
57	21,470	18,687	98,676	715,000	-1,155	22,081	52,066
58	23,575	21,280	119,957	770,000	-1,963	20,118	56,452
59	25,954	24,135	114,093	825,000	-2,914	17,204	60,815
60	28,642	27,286	171,379	880,000	-4,027	13,176	65,086
61	31,695	30,773	202,152	935,000	-5,336	7,839	69,169
62	35,176	34,642	236,795	990,000	-6,883	955	72,939
63	39,172	38,951	275,746	1,045,000	-8,725	-7,769	76,231
64	43,800	43,769	319,516	1,100,000	-10,943	-18,713	78,813
65	48,311	49,083	368,600	1,155,000	-12,797	-31,511	81,264
66	52,869	54,899	423,499	1,210,000	-14,448	-45,959	83,988
67	57,723	61,249	484,748	1,265,000	-16,127	-62,086	87,144
68	63,017	68,180	552,929	1,320,000	-17,955	-80,042	90,779
69	68,788	75,747	628,677	1,375,000	-19,943	-99,985	94,945
70	75,070	84,005	712,683	1,430,000	-22,096	-122,081	99,708
71	81,904	93,015	805,698	1,485,000	-24,425	-146,506	105,144
72	89,799	102,892	908,590	1,540,000	-27,381	-173,888	110,875
73	98,599	113,738	1,022,329	1,595,000	-30,758	-204,646	116,786
74	108,490	125,672	1,148,002	1,650,000	-34,682	-239,329	122,666
75	119,703	138,840	1,286,843	1,705,000	-39,311	-278,641	128,182
76	132,518	153,417	1,440,260	1,760,000	-44,838	-323,479	132,853
77	144,710	169,335	1,609,595	1,815,000	-49,071	-372,551	138,584
78	157,924	186,707	1,796,303	1,870,000	-53,590	-426,150*	145,573
79	172,211	205,650	2,001,953	1,925,000			154,067
80	187,597	226,286	2,228,239	1,980,000			164,396
81	204,136	248,741	2,476,981	2,035,000			176,946
82	221,789	273,138	2,750,119	2,090,000			192,256
83	240,548	299,598	3,049,717	2,145,000			210,987
84	260,431	328,245	3,377,963	2,200,000			233,889
85	281,463	359,206	3,737,170	2,255,000			261,803
86	303,673	392,611	4,129,781	2,310,000			295,652
87	327,064	428,588	4,558,369	2,365,000			336,479
88	351,614	467,265	5,025,635	2,420,000			385,461
89	377,257	508,764	5,534,399	2,475,000			443,963
90	403,838	553,186	6,087,585	2,530,000			513,609
91	431,083	600,605	6,688,191	2,585,000			596,394
92	478,846	653,278	7,341,469	2,640,000			674,524
93	535,396	712,172	8,053,641	2,695,000			743,989
94	602,841	778,484	8,832,126	2,750,000			799,548
95	685,424	853,881	9,686,007	2,805,000			832,809

Office of the Secretary of the Treasury
Office of Tax Analysis

January 31, 1984

Assumptions

1. Whole-life policy with initial face amount of $500,000 endowing at age 95 with annual premium of $10,971.
2. Contract pricing terms are 4 percent interest rate, 1980 CSO mortality rate table, and loading charges of 40 percent of gross premium in first year, 10 percent in second year, 5 percent in third through tenth year, and 2 percent thereafter.
3. Interest actually credited equals 10 percent.
4. Borrowing rate on the policy loan equals 11 percent.
5. Marginal tax rate of the policyholder equals 50 percent.
6. Currently applicable statutory interest rate of 11 percent continues indefinitely.
7. Definition of life insurance "corridor" proposed in S. 1992.
8. Borrows premium amount in only three of the first seven years, thereafter borrows all available cash value.

* Out-of-pocket costs in the year in which the interest limitation is reached and in subsequent years (if the policyholder lives that long) will depend on whether the borrowing continues and on other factors.

Senator **Chafee**. I would remind all members of the committee and the witnesses, too, that we have got a long schedule here today of witnesses. We want to move through them. We want to hear each of them. Apparently there are going to be some votes at 11:30. They have moved it now to 11:15. So we will have to move along. We are going to start off with the questions being limited to 3 minutes apiece, but if anyone wants a second round of questions, we will do that.

Now, Mr. Chapoton, there has been some suggestion that if there is an extension of the nondiscrimination rule to the amount of tax-free group term insurance provided to retirees that that would be adequate to prevent abuse and that we wouldn't have to have a $50,000 cap. Could you discuss that briefly?

Secretary **Chapoton**. That's correct. That suggestion has been made, and has been discussed with us. And we have looked at it. And certainly the extension of a nondiscrimination provision to retired employees would be an improvement over existing law. But we cannot find a basis for not applying the $50,000 limit to retired as well as to active employees. And as I point out in the statement, the failure to do so gives group term insurance tax benefits that are not enjoyed by qualified pension plans. So we just don't see the logic in doing so. We think you ought to grandfather very liberally existing arrangements. But we don't see the logic in the future of making that $50,000 applicable to retired as well as active employees.

Senator **Chafee**. Now what about the effective date of September 27, 1983? There seems to be some confusion. Suppose a plan is attended to liberalize it to some degree; where are the beneficiaries then?

Secretary **Chapoton**. I believe, as I understand the transition rules, Mr. Chairman, it is the amount of insurance that was in existence on that date. So if you had increased the insurance, the grandfather would not apply.

Senator **Chafee**. Now let's say that the present plan provided that retirees receive group term insurance in an amount equal to 1½ times their final salary. If they later amend the plan to provide two times salary, then the 1½ would be the only part that would qualify as tax free under the transition rule. Is there anything magic about the date? We've had some people who have said that——

Secretary **Chapoton**. I don't think there's any magic about the date. No, sir.

Senator **Chafee**. The provisions that you outline on the cumulative limits of the loans seem very generous. Was anyone aware of the cumulative possibilities when the legislation was originally introduced?

Secretary **Chapoton**. I don't know, Mr. Chairman. This is the type of, thing you have to put the pencil to. We have all focused on the fact that the limits were $250,000 and $500,000. And when you add the carryover, I think you have covered some policies that people did not realize they were covering.

Senator **Chafee**. What would be the effect if you did eliminate the cumulative part?

Secretary **Chapoton**. I think the limitation would still be a very generous limitation, but it would be appropriate.

Senator **Chafee**. I see. Thank you.

Senator Packwood.

Senator **Packwood**. For sake of brevity, Buck, I will not ask you about equity on this. There are other witnesses I will address it to. Let's talk about revenue. If we adopt a new definition of insurance, what's the revenue loss if we eliminate the policyholder provisions?

Secretary **Chapoton**. The elimination of the policyholder——

Senator **Chafee**. By policyholder provisions you mean all of them?

Senator **Packwood**. I would just as soon eliminate all of them. The revenue loss was—I'm curious about the revenue loss if we eliminate the policyholder provisions.

Secretary Chapoton. Staying away from annuities just a minute, Senator Packwood, because I think the marketing of tax oriented annuities does involve some revenue loss if there are not restrictions in that area. I would have to provide you with the figure, but that is a significant potential revenue loss.

Senator **Packwood**. But you are assuming things will happen that haven't happened to date?

Secretary **Chapoton**. I'm assuming that the marketing, the very vigorous marketing that did happen, indeed, before Revenue Ruling 81-255 came out, and that we are clearly seeing now active marketing of policies.

Senator **Packwood**. Buck, would you provide me with this then before we get to markup? One, your estimate of the revenue loss, assuming the inclusion of nondiscrimination and the new definition, assuming no inclusion of nondiscrimination and the new definition, if we eliminate the policyholder provisions, and how you got to those figures?

Secretary **Chapoton**. OK. Do you include in that—in annuities there is not the discrimination provisions.

Senator **Packwood**. Skip the annuities.

Secretary **Chapoton**. Well, in the others, I will be happy to provide that to you. I'm almost certain there is relatively little, almost no loss in the policyholder loan provision for one reason because existing policies are grandfathered so you don't have any effect, as our tables point out, for a number of years. But we could expect to see when those years pass a significant—we would expect to see now, as there has been, significant marketing of such policies. And, clearly, we think significant abuse possibilities. And at some point, obviously, the revenue would be affected. But it's going to be well into the future.

Senator **Packwood**. I just want to see your estimates.

Secretary **Chapoton**. OK.

[The information from Secretary Chapoton follows:]

The Treasury Department estimates that the policyholder provisions of S. 1992 would have a negligible revenue effect for fiscal years 1984, 1985, and 1986.

Senator **Chafee**. Senator Bentsen.

Senator **Bentsen**. Thank you very much, Mr. Chairman.

It seems to me that once you have a tough antidiscrimination rule on the $50,000 cap that you really preclude the employer trying to feather his own nest so to speak. And you have a social objective there that is a good one. And under those kind of conditions, then I don't see the limitation is necessary.

But I would like to get to the annuity question which you addressed earlier, Mr. Secretary. It seems inconsistent to me that on the one hand you tax the variable annuities in a manner similar to mutual funds. On the other hand, that on the distributions you treat them as though they were from a retirement account.

In addition to that, then on the mutual fund, as I stated earlier, the capital gain retains its character identified as a capital gain for the investor. But on the other hand, you don't have that kind of a characterization when you are talking about the annuity account. Now if we are going to be consistent and assume that we are trying to encourage long-term savings and an adequately insured—if you support that tighter definition of insurance. And on the other hand you say that you are going to be penalized if you distribute before 59½ years of age. Isn't it appropriate under those conditions to repeal the double taxation of capital gains on variable annuities?

Secretary CHAPOTON. Senator Bentsen, to be consistent here is almost impossible unless we went back and taxed annuities currently as mutual funds are now taxed because annuities enjoy a deferral. Now there is no tax except on the company level capital gains tax until the annuity is ultimately distributed, and so you get a tremendous tax savings while the funds are held in the company's pocket, credited to the account of the annuitant.

I will readily admit though that the capital gain tax at the company level is a tax here, and there is a second tax when the capital gain is distributed as ordinary income. What that really says is that annuities cannot broaden into the growth type mutual fund look-alike. But mutual funds would very much like to have the rules that annuities have.

Senator BENTSEN. Well, then why in the world would you say that you wouldn't want to encourage the investment in growth and in equities? It seems to me that that is a very good economic objective for our country.

Secretary CHAPOTON. Senator, what we would be going to do that is encourage the further imbalance. We would be giving the benefit not only of total tax deferral but the benefits of bringing this tax deferral into another area. But the mutual funds, banks and other intermediaries don't enjoy. There is almost no way to reach a level playing field here. But the main fight is that the mutual funds want in the annuities, the benefits the annuities have; not the reverse. I mean the benefits the annuities have are very, very significant. And the argument is that mutual funds are left out as they indeed are, and they want in. So I think the imbalance is in the other direction, and we are not going to reach level playing field here no matter what we do.

Senator BENTSEN. Thank you. My time has expired.

Senator CHAFEE. Senator Moynihan.

Senator MOYNIHAN. Thank you, sir. Chairman.

Mr. Secretary, welcome back to the New Year.

Secretary CHAPOTON. Thank you.

Senator MOYNIHAN. There is going to be much joy in your world. I have a question about a somewhat arcane aspect of Treasury rulings, one that perhaps you can help me with. That is the standardized letter the service sends out regarding to the composition of portfolios and basic underlying insurance. It provides that no more than 10 percent of any portfolio may be made up by any particular security. This 10-percent limit I understand applies to Treasury bonds as well.

This seems inconsistent from the Government's point of view. One part of your department is trying to sell the bonds, and the other side is trying to tell us that you can't buy more than a limited number. Have you any thoughts on that subject or is it just an everyday encounter.

Secretary CHAPOTON. Senator, I really don't. I haven't looked at that requirement at all.

Senator MOYNIHAN. Mr. Chairman, we have had a first. The first time Buck Chapoton hasn't had an answer for us. [Laughter.]

Senator CHAFEE. His average is good, as we all know.

Secretary CHAPOTON. Be happy to look at that. Certainly we do need to sell a few bonds. [Laughter.]

Senator MOYNIHAN. Thank you, Mr. Chairman.

Senator CHAFEE. Does anyone have any other questions of the Secretary? Senator Bentsen.

Senator BENTSEN. No.

Senator CHAFEE. Thank you very much, Mr. Secretary. Obviously, we will be consulting with you further as we consider this very complex piece of legislation.

Secretary CHAPOTON. Thank you, Mr. Chairman.

Senator CHAFEE. The next panel will consist of former Senator Schweiker; Mr. Phillips; and Mr. Rolland. Gentlemen please step right up to the desk, And if you could limit your statements to 3 minutes, that would be helpful.

STATEMENT OF HON. RICHARD S. SCHWEIKER, PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE, WASHINGTON, D.C.

Senator SCHWEIKER. Mr. Chairman, and members of the committee, I am Richard S. Schweiker, president of the American Council of Life Insurance [ACLI]. With me are Ian M. Rolland, chairman and chief executive officer of the Lincoln National Life Insurance Co., and chairman of the board of directors of the ACLI; and Edward E. Phillips, chairman and chief executive officer of the New England Mutual Life Insurance Co., and chairman-elect of the board of directors of the ACLI.

The ACLI is a trade association representing over 600 life insurance companies which in the aggregate account for approximately 95 percent of the life insurance in force in the United States, and hold 98 percent of the assets of all the U.S. life insurance companies.

We are here to state the position of the ACLI regarding the provisions of S. 1992, the Life Insurance Tax Act of 1983. The ACLI strongly supports S. 1992.

Mr. Chairman, as you know, this proposed legislation reflects many months of work, negotiation, and compromise to resolve numerous complex and sensitive issues. In its basic structure, it has the broad based support of the insurance industry, including both mutual and stock companies. The bill will simplify and improve the taxation of life insurance companies, and will provide needed certainty to a number of issues that have arisen in this area.

Mr. Chairman, we urge the committee to act as promptly as possible on this legislation. As you know, the temporary TEFRA law expired on December 31 of last year. A new permanent law this year is absolutely critical for our industry. It is needed for proper investment, business planning and product design purposes. We cannot over-emphasize the absolute need we have for legislation at the earliest possible time.

We understand that some technical amendments may be needed. We further understand that changes are being considered in the tax treatment of life insurance companies with respect to variable life insurance and annuity contracts. We believe that such changes are appropriate and that they would not change the thrust of the legislation. In its current form, the bill would deny a deduction for a portion of the benefit payment or reserve increase set aside for variable contract policyholders that is funded by capital appreciation. Such amounts are fully deductible, as they should be, if credited under other types of policies.

Other witnesses will address this issue in more detail.

In closing, Mr. Chairman, we appreciate the efforts that have been made by you, the members of this committee, and its staff to meet our industry's urgent need for permanent tax legislation.

We thank you for this opportunity to testify, and we will be pleased to respond to any questions.

Senator CHAFEE. Thank you, Senator. We will defer the questions until each member of the panel has given his statement.

[The prepared statement of Senator Schweiker follows:]

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE BEFORE THE COMMITTEE ON FINANCE CONCERNING THE TAX AMENDMENT OF LIFE INSURANCE PRODUCTS AND POLICYHOLDERS

JANUARY 31, 1984

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am Richard S. Schweiker, President of the American Council of Life Insurance (ACLI). With me are Ian M. Rolland, Chairman and Chief Executive Officer of the Lincoln National Life Insurance Company and Chairman of the Board of Directors of the ACLI and Edward E. Phillips, Chairman and Chief Executive Officer of the New England Mutual Life Insurance Company and Chairman-elect of the Board of Directors of the ACLI. The ACLI is a trade association representing over 600 life insurance companies which, in the aggregate, account for approximately 95 percent of the life insurance in force in the United States and hold 98 percent of the assets of all United States life insurance companies.

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In closing, Mr. Chairman, we appreciate the efforts that have been made by you, the members of this Committee and its staff to meet our industry's urgent need for permanent tax legislation. We thank you for this opportunity to testify and will be pleased to respond to any questions.

Senator CHAFEE. I recognize a fellow New Englander, Mr. Phillips. Please proceed.

STATEMENT OF EDWARD E. PHILLIPS, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, NEW ENGLAND MUTUAL LIFE INSURANCE CO., BOSTON, MASS.

Mr. PHILLIPS. In the interest of time, I don't think we have any statement. We will be glad to respond to questions.

Senator CHAFEE. Well, we can't beat that.

Before we start, I want to welcome our distinguished chairman, Senator Dole, who has arrived and is knowledgeable in this field. Indeed he has taken a great interest in this legislation. Senator Dole, do you have any statement?

The CHAIRMAN. I have a statement which I will put in the record.

[The prepared statement of Senator Dole follows:]

OPENING STATEMENT OF SENATOR DOLE

Today the Finance Committee will have an opportunity to receive testimony on a number of proposed changes in the taxation of certain products sold by life insurance companies and the taxation of insurance customers themselves. I am especially pleased today to welcome Congressmen Pete Stark and Henson Moore, who have labored long and hard on these issues in the House, and whose insights will surely be of great help to us.

While the issue of the life insurance company taxation has generated substantial comment and has been the subject of much analysis, it seems to me that the taxation of life insurance products and policyholders has received much less attention. However, it is appropriate that, if Congress is to address the issue of life insurance company taxation, it should at the same time address the issues involved in the taxation of life insurance products. From a tax policy point of view, the taxation of products and life insurance customers is inextricably connected with, and of equal importance to, the taxation of life insurance companies. The industry has based much of its product design on the tax benefits which are accorded life insurance and related products. Probably no other industry is as sophisticated in the design of products to maximize tax benefits.

DEFINITION OF LIFE INSURANCE

One area of concern is the definition of life insurance. Prior to enactment of the Tax Equity and Fiscal Responsibility Act, there were no guidelines to determine what was a life insurance contract primarily designed to provide death benefit protection and entitled to related tax benefits and what was essentially an investment contract. Congress established certain guidelines in TEFRA for "flexible premium" life insurance products. These guidelines were in effect for 1982 and 1983. S. 1992 would establish similar guidelines which would, however, apply to all life insurance contracts. Since the guidelines were derived from the flexible premium guidelines, it is important that the Finance Committee have an opportunity to learn what impact these guidelines would have upon traditional products and especially on the products sold by companies who had no reason to comment on the development of the TEFRA guidelines.

VARIABLE PRODUCTS

Of secondary concern is the treatment of variable annuities and variable life insurance. In a variable contract a customer has the risk of investment experience, unlike traditional products where the cash value of the contract is guaranteed by the insurance company and not subject to loss. Under present law there is a major difference in the treatment of variable life insurance and variable annuities. Variable annuities are accorded significantly less favorable tax treatment than variable life insurance, essentially because Congress was concerned that, if the tax treatment of variable annuities was made more attractive, the variable annuities would unfairly compete with mutual funds. S. 1992 would extend the tax treatment of annuities to variable life insurance. I am pleased that we have several representatives of companies who sell variable contracts and look forward to their comments on the proposed changes.

ANNUITIES

Much of the concern about the variable annuity tax rules centers on how comfortable Congress is that the basic rules for taxation of annuities generally are adequate to accomplish the goals desired by Congress and to prevent the use of annuities as ordinary investment vehicles. S. 1992 would impose penalties similar to individual retirement accounts for withdrawals prior to typical retirement age. The penalties would, however, be imposed at half the IRA penalty rate. In TEFRA Congress imposed early withdrawal penaltises for as maximum of 10 years. We should explore whether the rate of penalty and time period are adequate to insure that annuities are used, not as general savings vehicles, but as tax-preferred savings for retirement purposes.

GROUP TERM LIFE INSURANCE

A fourth area that is addressed by S. 1992 is group term life insurance for retirees, S. 1992 imposes requirements that such life insurance must be provided on a nondiscriminatory basis, and also that the same $50,000 cap on excludable life insurance must be applied to retirees and active employees. Some have questioned whether these two requirements are appropriate to prevent use of group term life insurance as a special retirement or severance arrangement for key employees. It will be helpful to hear from witnesses whether there are any abuses allowable under present law and whether merely imposing a nondiscrimination rule, for example, would be sufficient to prohibit any abuses.

POLICYHOLDER LOANS

A fifth issue is whether any limitations should be imposed on the ability to take an interest paid deduction for interest paid with respect to loans from a life insurance policy. The limitations imposed in S. 1992 are at very generous levels, and a question is presented whether these limitations will have any impact at all in the marketplace and whether current law has allowed potentially abusive policies to be marketed.

NONDEDUCTIBLE IRA'S

Finally, S. 1992 also would allow taxpayers to make nondeductible IRA contributions of up to $1,750. Several questions, in addition to revenue impact, are presented by this new savings incentive, not the least of which is the impact on the marketing of traditional annuities.

In conclusion, these hearings will provide an opportunity to hear the views of sponsors, Treasury, life insurance companies, agents, and other interested persons. I am sure the testimony will be helpful to the committee in its further deliberations in this area.

Senator **CHAFEE**. Well, we are going along very nicely. [Laughter.]

The **CHAIRMAN**. I understand we have three votes starting at 11:15 so it's going to be a long day unless we move.

Senator **CHAFEE**. Right. One question. Obviously, by supporting this legislation you are supporting the $50,000 cap on tax free group term insurance for retirees and also the limitations on the deductibility of interest on certain policyholder loans.

Mr. **ROLLAND**. Well, I would say if any of us individually had to write this legislation we would probably do it differently. But it is a combination of compromises which we in the ACLI and the stock and mutual segments of our industry have agreed to support. As we have said, we support the legislation very strongly. It is a package of compromises that we think will benefit our industry.

Senator **CHAFEE**. Fine.

Senator **SCHWEIKER**. I wonder if we could just ask for a mutual comment on that.

Senator CHAFEE. Yes.

Mr. Phillips.

Mr. PHILLIPS. Yes, Mr. Chairman, I would concur with the statement Mr. Rolland has made and emphasize how badly we who are trying to operate life insurance companies in this country need tax legislation.

Senator CHAFEE. Fine. Thank you.

Senator Packwood.

Senator PACKWOOD. Mr. Phillips, you are a mutual?

Mr. PHILLIPS. Yes, sir.

Senator PACKWOOD. We are well versed in this committee with interest groups and companies alerting their shareholders, stockholders, depositors and what not to write us in volumes about things we might pass in this committee they don't like, one of the latest being the withholding on interest and dividends.

You are owned by your stockholders, your policyholders. What action did you take to notify them as to the affect on the policyholder that this legislation might have?

Mr. PHILLIPS. No action, Senator.

Senator PACKWOOD. No action at all?

Mr. PHILLIPS. That's correct.

Senator PACKWOOD. If the policyholder provisions in this bill, and especially the limits on deductibility of interest and the amount of group life, were eliminated, would you still support the bill?

Mr. PHILLIPS. If the provisions in the bill presently with restrictions on the amount of deductibility of policy loan interest were removed, I would not be able to support that change unless someone could guarantee me that it would not impair passage of the bill. It is not certainly a provision that starting from scratch, Senator, I would have chosen to include in the bill. But on the other hand, there are a couple of dozen more that I wouldn't have chosen to include in the bill either.

Senator PACKWOOD. I might be able to guarantee you that if they are not removed, I will do the best I can to insure that no bill is passed.

Mr. PHILLIPS. Yes, sir.

Senator PACKWOOD. You can pay your money and take your choice as to which way you want to go. [Laughter.]

Now let me ask the question again with that premise. Assuming the bill will be passed, will you support the bill if we eliminate the limits on amount, eliminate the amount on the group life insurance?

Mr. PHILLIPS. Well, it's a very delicate question for me to attempt to answer. The American Council of Life has taken the position of support of S. 1992 as is, as a result of a great deal of difficult compromise activity, which I am sure you are aware, Senator. If you ask me to pick it apart and say what I supported if such and such or so and so was dropped out, you are putting me in a very difficult position.

Senator PACKWOOD. With your permission, I would like to do that.

Mr. PHILLIPS. With your permission, I would like to repeat in part my first answer and say provided the bill would pass so we would get tax legislation essentially as it is today with that one provision, would that cause me as representing New England Life to abandon my support of the bill, I think the answer to that is no, sir, it would not.

Senator PACKWOOD. Mr. Rolland.

Mr. ROLLAND. I would say the same thing. If you can assure us passage of this legislation, I would just emphasize the importance of getting this very quickly. If you could guarantee that passage, obviously, the elimination of these provisions would not cause us or me personally to withdraw support. But that's a pretty big stipulation up front, I would say.

Senator PACKWOOD. I have no further questions, Mr. Chairman, other than to comment it is easier to stop legislation than to pass it.

Senator CHAFEE. Senator Bentsen.

Senator BENTSEN. Thank you, Mr. Chairman.

I think there is some confusion with respect to the proposal to amend the treatment of the variable contracts under this bill. And there is some perception on the part of people that this is a means of life insurance companies being able to avoid capital gains tax. However, as I understand what you are trying to do, you are talking about the discriminatory treatment because capital gains are included in the income of a life insurance company. But the company doesn't get any deduction if you set that capital gains aside for that particular policyholder. Isn't that really what we are getting to?

Mr. PHILLIPS. It seems to me, Senator, in this legislation you have established a very important principle and that is amounts credited to customers should be fully deductible. That's a part of this bill we strongly support. These capital gains on both variable annuity and variable life contracts are amounts credited to customers. It seems to me, therefore, that consistent with the basic principle of this legislation that it makes sense for companies to have full deductions for these capital gains. I don't see that it is essentially different from our ability to get full deduction for dividends and interest on other kinds of investments.

Senator BENTSEN. It adds up to the same thing.

Senator CHAFEE. Thank you. Senator Dole.

The CHAIRMAN. I would just ask either the other witnesses or you two questions. How many life insurance policies issued by your company would be affected by the policy loan provisions of S. 1992? And what percentage of your policies would be affected?

Mr. PHILLIPS. I would answer, Senator Dole, by saying that we have not been able to determine that exactly, but it would be a very small percentage.

The CHAIRMAN. A very, very small percentage.

Mr. PHILLIPS. Yes, sir.

The CHAIRMAN. Maybe you could supply that for the record.

Mr. PHILLIPS. Yes, sir. I would be happy to try.

[The information from Mr. Phillips follows:]

New England Mutual Life Insurance Co.,
Boston, Mass., February 22, 1984.

Hon. Edgar R Danielson,
Senate Committee on Finance,
Washington, D.C.

Dear Mr. Danielson: You have asked us to review the testimony of Mr. Edward E. Phillips, Chairman of the Board and Chief Executive Officer of New England Life, which was presented to the Senate Finance Committee on January 31, 1984. Enclosed is a copy of the transcript as requested. I have reviewed this testimony and find that no changes are required.

In addition, Mr. Phillips was asked to submit information in respect to the percentage of New England Life's policies which would be affected by the policy loan provisions of S. 1992.

At the request of Mr. Phillips, I submit the following response to you for the record: "Based upon an analysis of our policies records, there are presently less than 1 percent of the policies now in force with loans that today would be affected by the policy loan provisions of S. 1992. However, although we can't state precisely how many of our present policies would in the future be affected by the policy loan limitations of S. 1992, we are confident that the numbers of such policies could increase substantially from the present numbers actually determined."

Please let me know if you need any additional information.

Respectfully yours,

Kernan F. King.

Senator Chafee. Did you say policy loan provisions?

The Chairman. Yes. Policy loan provisions.

If I may ask another question, what is the most typical amount of group term life insurance? One times salary? Two times salary?

Mr. Phillips. I would say somewhere in the neighborhood of one or two times salary would be a fairly typical group insurance benefit.

Mr. Rolland. That would be our experience, too, Senator.

The Chairman. Let's just assume you had an employee with a $33,000 salary and a life insurance benefit of three times salary, $100,000. What would be the tax cost of this benefit under S. 1992, assuming a retiree at age 65 with an average pension benefit and no other significant income other than social security?

Mr. Rolland. You would have a tax on of $50,000 of group term life. I think the total taxable income for that amount of insurance would be somewhere in the neighborhood of $600 or $700 per year. I think the tax in that case is probably no more than $100 per year.

The Chairman. Let me just continue Senator Packwood's comments. We understand there is some urgency in getting this legislation passed. We are going to have only one tax bill this year, hopefully, and we would like to put it all in one little package or one big package, depending on your point of view. And so if you can help us get together this down payment on the deficit, we will put all this in a nice little package and put it on the reconciliation bill, which is on the Senate floor, and, hopefully, pass it by April, and then go home. That would be my wish.

If you are really interested in getting the life insurance package passed then help us with all the others. You have a lot of contacts up here.

Senator Schweiker. We have the message, Senator.

Mr. Rolland. And, Senator, I would say we have already started a very extensive lobbying effort in our industry in both the House and the Senate to try and get our bill passed. I would say this, that just to emphasize the absolute importance of getting this legislation passed this year we are trying to run our companies and price our products in an atmosphere of total uncertainty about our taxation. And I would say we will do our best to help you with your tax bill, but I hope that there would be a recognition of our problems ultimately as well.

The **Chairman**. My comments shouldn't be construed any hostility toward the life insurance industry.

Mr. **Rolland**. I understand.

The **Chairman**. It's just a matter of hard, cold facts. I mean any bill you move out here is going to be amended with 50 or 60 amendments on the Senate floor unless we have some arrangement or some package. Whether it was mortgage revenue bonds or life insurance or leasing or whatever it is, it is open to amendment on the Senate floor. So what we need is for the House to pass that little revenue bill that is tied up with the IDB fight and send it to us, and then we are in a position to amend it and go to conference.

I think we have fair agreement on this committee. We have some differences on the level of revenue and things of that kind, but those issues are not too hard to resolve out.

Senator **Schweiker**. Mr. Chairman, I think it should be made clear on the record that the position of the ACLI is frankly to try to do something in support of the deficit problem. That historically has been our position. That's our Economic Subcommittee's position so we are basically in support of your efforts, and have been for some months. And we commend you for them.

We certainly will do what we can to help. One of our problems is we are sort of a popular industry because over in the House they want us to help get the IDB bill through too. And we are sort of piggy-backing on that. And I just hope that in the process we can get our own bill through.

But we certainly are going to try to do what we can.

The **Chairman**. It would be awful if you got all the other bills through and not yours, wouldn't it? [Laughter.]

Senator **Chafee**. Thank you very much, Senator.

The next panel consists of Mr. Morton of John Hancock Mutual Life Insurance; Mr. Garber; Mr. Thomas Anderson; and Mr. Edwin Cohen.

Mr. Morton, why don't you start right off.

STATEMENT OF E. JAMES MORTON, PRESIDENT AND CHIEF OPERATIONS OFFICER, JOHN HANCOCK MUTUAL LIFE INSURANCE CO., BOSTON, MASS.

Mr. **Morton**. Thank you, Senator. I'll be brief because I know time is limited. My name is James Morton, and I am president of the John Hancock Mutual Life Insurance Co. I am happy to be able to appear here today.

Senator **Chafee**. Now I don't know how long your statement is, but if you could summarize it in 3 minutes, we would appreciate it.

Mr. **Morton**. It is going to take 1 minute, I hope.

We generally support S. 1992. We believe that it's a reasonable approach to a permanent tax structure for the life insurance business. The reason I'm here today is to urge the committee to eliminate that provision of S. 1992 which would impose a new and unique tax on variable life insurance by reserve deduction limitation.

You have heard about this in previous testimony from Dick Schweiker and also from Secretary Chapoton. I don't think that I have to go into the details. But we have in variable life insurance a product which is clearly a life insurance product. As a matter of fact, it is rapidly becoming John Hancock's principal life insurance product. It requires specified premiums and provides a guaranteed death benefit. The amount of life insurance may be adjusted to reflect investment experience, but it may never fall below the initial guaranteed death benefit.

Whatever the investment results may be, all of the investment income is used to provide additional life insurance. So this is really a life insurance policy.

This product has a lot of consumer appeal. We expect more than half our business in 1984 to be sold in this form. And so I urge that your committee amend the bill to remove the discriminatory tax burden on this product.

Mr. Garber and I have a prepared statement that we filed with you that goes into much more detail, and explains how we believe that this could be done.

I am ready to answer any questions.

[The prepared joint statement of Mr. Morton and Mr. Garber follows:]

STATEMENT BY

MR. E. JAMES MORTON, PRESIDENT AND CHIEF OPERATIONS OFFICER
OF JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY
AND
MR. HARRY D. GARBER, SENIOR EXECUTIVE VICE PRESIDENT AND
CHIEF FINANCIAL OFFICER OF
THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES

ON

TREATMENT OF VARIABLE LIFE INSURANCE IN
S. 1992 -- THE LIFE INSURANCE TAX BILL OF 1983

TO

COMMITTEE ON FINANCE
UNITED STATES SENATE
January 31, 1984

Equitable and John Hancock market variable life insurance ("VLI") through subsidiaries as one of their major products. VLI is a relatively new form of life insurance under which the death benefit varies, but never below the initial face amount, based on the investment performance of a life insurance company separate account.

While Equitable and John Hancock support the basic provisions of S. 1992, The Life Insurance Company Tax Bill of 1983, we urge that the specific company tax section applicable to VLI be revised to eliminate a new and highly discriminatory tax burden that would otherwise be imposed on this important product in the individual life insurance market.

This is not a mutual-stock issue. Our position has the support of both stock and mutual companies offering, or contemplating the offer of, this product. A list of companies endorsing this statement is appended hereto.

Since Equitable and John Hancock have more VLI in force than any other companies, we are in a unique position to offer our experience and expertise to the Committee and thus we have been asked to take the lead in making this statement. As indicated by the attached endorsements, many other life insurance companies either have entered, or are about to enter, the VLI market and have incurred considerable developmental cost in the process.

SUMMARY OF PRINCIPAL POINTS

1. S. 1992 unfairly discriminates against variable life insurance by denying the life insurance company a deduction for amounts of capital gain income credited to reserves for policyholders. In the case of every other life insurance product, S. 1992 allows deductibility of all amounts credited to or for the benefit of policyholders.

2. Such treatment is unwarranted because VLI qualifies as life insurance under the bill and is not an investment product. It competes with other life insurance products, not investment funds.

3. Unless S. 1992 is changed to eliminate the discriminatory company tax burden, VLI will not be competitive with other life insurance products and companies issuing it will suffer irreparable harm.

4. A proposed compromise offer to allow policyholders a basis adjustment does not eliminate the discrimination as against other types of life insurance. The only reasonable solution is to eliminate the discriminatory company tax burden on VLI.

DISCUSSION

1. S. 1992 materially discriminates against VLI.

S. 1992 (and its counterpart, H.R. 4170) imposes a unique tax burden on VLI to the extent that the reserve supporting the death benefit is funded by investment income in the form of capital gains. The bill, in effect, discriminates against VLI solely on the basis of the type of investment income used to fund the death benefit. The new tax burden is imposed by denying a deduction for amounts added to reserves for policyholders. It is a tax burden not imposed on VLI under either the 1959 Act or the stopgap legislation.

To single out a particular source of income as a basis for denying a reserve deduction is not a rational basis for taxation; no similar tax is imposed by S. 1992 on other life insurance products (including universal life) with which VLI must compete or even on a VLI policy which generates only ordinary income.

Under S. 1992, as applied to life insurance products generally, items of investment income -- including capital gains -- are offset by a tax deduction for reserve or benefit additions generated by such investment income. For life insurance products other than VLI, reserve increases are deductible without regard to the source of the income giving rise to the reserve or benefit increase. Thus, all forms of investment income for such life insurance products, including capital gains, can be fully passed on to the policyholders without imposition of tax at the company level. Only in the case of variable contracts is a different rule prescribed.

Whether the investment return is in the form of dividends and interest or appreciation in the value of the underlying investments or, as is most common, a combination of both, should be irrelevant for purposes of determining the amount of the reserve deduction.

In fact, in the case of common stock investments, the form of the investment return (i.e., dividends or appreciation in the value of the stock) will depend on the decision of the payor corporation as to what portion of its earnings to retain and what portion to distribute as dividends, a matter outside the direct control of the insurance company investor.

2. VLI is life insurance, not an investment product.

VLI has been on the U.S. market since 1976 and is now offered by a number of major life insurance companies, both mutual and stock. VLI accounts for almost 50 percent of John Hancock's, and 25 percent of Equitable's, new sales of individual life insurance.

VLI appeals primarily to middle income individuals seeking life insurance protection with a hedge against the effects of inflation. The average annual premium for John Hancock VLI policies is a modest $550 and for Equitable, about

$890. Over half of Equitable's VLI policy sales in the first 9 months of 1983 were for the minimum face amount of $25,000. Almost two-thirds of John Hancock's individual life insurance sales to middle income buyers now consist of VLI.

VLI is designed to do basically the same thing as more traditional forms of life insurance: that is, provide life insurance protection. The unique feature of variable life insurance is that the death benefit is automatically adjusted to reflect the investment performance of assets maintained by the company in a separate account funded by the premiums from the VLI policyholders. (The death benefit can never fall below the initial face amount, however, regardless of the investment performance of the underlying assets.)

VLI essentially offers policyholders a means to have their life insurance coverage automatically adjusted to meet current economic conditions, particularly in times of inflation.

Although the policyholder bears some of the investment risk under the policy in relation to benefits provided above the initial face amount of insurance, the issuing company nonetheless bears all of the risk of adverse mortality experience, thus making the policy one of life insurance for Federal tax purposes under the historical test laid down by the

United States Supreme Court in the landmark case of Helvering v. LeGierse, 312 U.S. 531 (1941).

There is nothing in the VLI design that would warrant the discriminatory tax treatment in S. 1992:

- As in the case of traditional whole life insurance, a VLI policyholder pays a level fixed premium and in return is guaranteed a specified minimum death benefit. The premium for a VLI policy with a specified guaranteed death benefit is comparable to that of a traditional fixed benefit policy with the same face amount.
- Although the death benefit may be adjusted from time to time pursuant to the variable feature, it will never be less than the initial level.

Unlike a mutual fund, in which investment return is reflected dollar for dollar, VLI converts each dollar of favorable investment experience into multiple dollars of additional life insurance which would qualify as such under the definition of life insurance contained in S. 1992. Under the John Hancock design, the ratio of death benefit to cash value is never less than under a comparable traditional level premium whole life insurance policy. Under the Equitable design, each increment has a ratio of death benefit to cash value equal to that under traditional paid-up additions for a like amount.

As a life insurance product, VLI involves the usual mortality and expense charges. It does not, and cannot, compete with investment vehicles such as mutual funds. If, for example, a policyholder surrenders his VLI policy after a period of favorable investment experience, the surrender value will not reflect all of the favorable experience since a significant part will have been applied to provide additional life insurance protection.

Purchases of VLI are made to provide basic life insurance protection and not investment return. No one interested purely in fund accumulation would buy VLI; fund accumulation is merely incidental to the life insurance protection provided under such a policy.

However, to eliminate any possibility of abuse, S. 1992 contains a definition of "life insurance" intended to exclude overly investment-oriented products from favorable treatment as life insurance. That definition applies to VLI in the same manner, and with the same safeguards, as in the case of traditional life insurance, thus assuring that VLI will qualify as life insurance only if it continuously meets the tests of the bill.

3. Unless the bill is amended to eliminate the discriminatory company tax burden, VLI will be noncompetitive with other life insurance products and the companies issuing it will suffer irreparable harm.

The proposed tax burden would irreparably harm the development of VLI, which is a very important product from the standpoint of both policyholders and the life insurance industry.

It offers an option that ought to be available to consumers on a tax-neutral basis. Instead, S. 1992 puts a tax penalty on this option.

The competitive effect on VLI of such disparate treatment would be magnified by the fact that the new tax burden would have to be described in the prospectus to be furnished in connection with the sale of VLI. This would lessen the task of selling a competing product; the salesperson for that product could point to the discussion of the tax burden in the VLI prospectus and make the argument that, since his product does not have such a tax burden, it can presumptively return more to the policyholder (even though this may not in fact be the case because of different gross investment yields and expense and mortality charges).

To be competitive in the marketplace, all permanent life insurance products, including VLI, require the life insurance company to invest premium dollars and realize a competitive return on that investment. If a VLI policy earns an annual return of 12 percent, of which one-third represents realized long-term capital gains, the tax resulting from the disallowance of the reserve deduction attributable to the capital gains would amount to 112 basis points (1.12 percent!), a disparity in return which the issuer would have to disclose and in light of which the existing product could not survive in the marketplace.

It is true that present law denies a reserve deduction (with no offsetting income adjustment) for amounts attributable to capital gains in the case of nonqualified variable annuities. This tax treatment of variable annuities, however, is not a useful precedent. It was developed in 1962 against a different historical background and is not based on any sound tax principle. Instead, it discriminates against variable annuities as compared with their general account counterparts. The present variable annuity treatment should be corrected; the inequities in this treatment should not be compounded by extending them to VLI.

In fact, because of this discriminatory tax, many companies have been effectively forced out of the nonqualified variable annuity market, while other companies have significantly limited the types of investments under these policies. This is what happens to an insurance product when the tax law discriminates against it materially in favor of competing products.

4. A Policyholder Tax Basis Adjustment is Not a Viable Compromise; the Discriminatory Company Tax Burden on VLI Should Be Eliminated.

In an effort to mitigate the effects of double taxation of variable contract capital gains under the bill (first, a capital gains tax of 28 percent at the company level and then an ordinary tax on the net gain realized by the policyholder in case of surrender), it was suggested during the House consideration of the tax bill last fall that a possible compromise of the issue might be to allow the policyholder to increase his tax basis, for purposes of determining his taxable income on a surrender, by the amount of any separate account capital gain income previously taxed to the life insurance company.

The compromise is fundamentally objectionable in that while it would prevent a double tax on capital gains in the event that the policyholder were to surrender his policy before death, it would have no effect in the case of a policyholder who keeps his policy until death. In the case of such a policyholder, who has used the policy for its primary purpose of providing life insurance protection, a basis adjustment is irrelevant.

Moreover, the compromise proposal does not deal with the most fundamental objection of all that VLI would remain as the sole life insurance product which would be subjected to a tax burden on income, i.e., capital gains, set aside in policyholder reserves.

Finally, the compromise rule is so foreign to the treatment of life insurance generally that it would require a radical change in the marketing and administration of VLI as well as a substantial re-education of the policyholder.

Proposed Amendment

Accordingly, S. 1992 should be amended to eliminate the above discriminatory treatment of VLI and thereby allow it to compete on an equal footing (i.e., a tax-neutral basis) with other life insurance products in the marketplace.

As indicated above, the adverse tax burden on VLI occurs under S. 1992 because proposed new Section 817(a)(1) of the Code cancels out reserve additions (which would otherwise be deductible) to the extent they are attributable to realized or unrealized capital gains. The proposed new Section 817(d)(2) provides a compensating increase in the company tax basis of the assets in the separate account to offset the loss of the reserve deduction, but only in the case of pension plan contracts.

The discriminatory tax treatment of VLI should be eliminated by amending the company tax basis adjustment provisions of proposed Section 817(d)(2) to allow such company basis adjustment for all variable life insurance contracts, whether or not sold to pension plans. (We understand that other witnesses here today will present a similar case for extension of such basis adjustments to variable annuities.)

This amendment would produce a tax for VLI consistent with life insurance reserve tax accounting principles generally applicable under S. 1992. It would have a negligible effect on revenue. It cannot result in a reduction of Federal tax revenues since there is presently no tax burden on VLI capital gains under the 1959 Act or the stopgap legislation. Furthermore, if S. 1992 remains in its present form, individuals who would otherwise have purchased VLI policies will simply switch to other kinds of life insurance policies, and there will be no new tax revenues generated. As noted, this has been the experience under the present tax structure with respect to nonqualified variable annuities.

* * * * *

In conclusion, we urge the Committee to revise S. 1992 in the manner we have proposed in order to allow VLI to provide maximum benefits to its policyholders and to compete with other life insurance products. We would be happy to attempt to furnish any additional information which the Committee may think helpful and to work with staff.

Respectfully submitted,

E. James Morton,
President and Chief Operations Officer
John Hancock Mutual Life Insurance Company

Harry D. Garber,
Senior Executive Vice President and Chief Financial Officer
The Equitable Life Assurance Society of the United States

APPENDIX

We have been authorized by the following life insurance companies to indicate that they endorse this statement on the tax treatment of variable life insurance in S.1992:

Bankers Security Life Insurance Society

Home Life Insurance Company

Massachusetts Mutual Life Insurance Company

Metropolitan Life Insurance Company

Monarch Resources, Inc.

New England Mutual Life Insurance Company

New York Life Insurance Company

The Northwestern Mutual Life Insurance Company

Provident Mutual Life Insurance Company of Philadelphia

The Prudential Insurance Company of America

Senator CHAFEE. I take it the balance of the witnesses are going to agree with your point of view. It would be helpful if you would also try to address the arguments that you heard Mr. Chapoton raise.

Please begin, Mr. Garber. Do you agree with Mr. Morton?

STATEMENT OF HARRY D. GARBER, SENIOR EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES; NEW YORK, N.Y.

Mr. GARBER. Yes, I'm on the same line. I think the arguments that Mr. Chapoton has made on variable life were very supportive of the industry position so that I don't know how much I may be beating a dead horse here in doing this. There are two important things to stress on this subject. One is that having established definitions of life insurance which apply to all kinds of life insurance, and variable life will meet those definitions at all points, I believe that the chance this product will be competitive with mutual funds or of interest to mutual fund policyholders is very remote. So the comparisons here ought to be made with other life insurance policies.

I have one sentence on the mutual fund comparison that I would like to read for the record: "There is no basis for building the VLI tax structure based on another type of product sold to different customers by different salespeople for different purposes." I think both Mr. Morton and I find that the variable life insurance product is sold essentially to middle income people. The amounts of premium per year are relatively small. It is used for life insurance, and it is not an investment product.

Further, we have found that the termination rates under this product, although it's early in the market, are comparable or a little bit lower than regular life insurance. So people aren't using it as an investment, but they are using it like a regular life insurance policy.

My second point—and I'm not sure whether Buck covered this or not—is that, in fact, the proposal to extend the present rule for variable annuities to variable life, the taxation of the reserve increases attributed to realized capital gains, is an aberration in the Tax Code. This was a solution that was developed in 1959 in a great big hurry to solve an apparent problem between variable annuities and mutual funds. It's a pragmatic, one of a kind, solution that is nowhere else in the code. The practical effect has been to price variable annuities out of the market. Very few variable annuities have been sold. So it is clearly overbalanced as a solution. This is not a model to extend to variable life insurance because it has even less applicability to variable life than it does to variable annuities.

I will be glad to answer any questions.

Senator CHAFEE. Well, we will get to the questions when we hear from the full panel.

STATEMENT OF THOMAS R. ANDERSON, CHIEF EXECUTIVE OFFICER, KEMPER INVESTORS LIFE INSURANCE CO., CHICAGO, ILL., ON BEHALF OF THE COMMITTEE OF ANNUITY INSURERS, WASHINGTON, D.C.

Senator CHAFEE. Mr. Anderson.

Mr. ANDERSON. Thank you, Senator.

My name is Thomas R. Anderson. I am the chief executive officer of Kemper Investors Life, and I am testifying on behalf of the Committee of Annuity Insurers, which is a group of 22 leading annuity writers.

Overall, we support the enactment of the bill before us, S. 1992, with an amendment dealing with capital gains tax on variable contracts. Specifically, we believe that the capital gains tax at the company level on nonqualified variable annuity contracts needs to be eliminated.

This tax is clearly unfair and unwarranted. And it's contrary to the tax treatment of all other annuity insurance products. We submit that a variable annuity contract is a very important and socially desirable financial planning vehicle. It is a retirement vehicle. And I believe that TEFRA, as well as this bill before you gives you great assurance that it is a retirement savings vehicle. I have to ask why we are trying to discriminate against such a socially desirable product. I also ask why we are discriminating against equity investment as a funding vehicle for these types of retirement products

Therefore, this is clearly an issue of double taxation. There is a tax at the capital gains rate at the company level, followed at a later date by an ordinary income tax rate to the individual when he starts taking it out. That is clearly unfair, and it is clearly double taxation

We are aware of the "basis adjustment alternative" which has been proposed by the staff. In our opinion this fails for several reasons. One, it would be very difficult and costly to administer.

Second, it would be confusing if not totally incomprehensible to policyholders, and finally there is really no revenue gain to the Treasury when compared to our proposal.

Again, I would be happy to answer any questions later.

Senator CHAFEE. Thank you.

[The prepared statement of Mr. Anderson follows:]

STATEMENT
OF
THOMAS R. ANDERSON
ON
BEHALF OF
THE COMMITTEE OF ANNUITY INSURERS
ON
S. 1992

COMMITTEE ON FINANCE
U.S. SENATE

January 31, 1984

Mr. Chairman and other distinguished Members of the Senate Finance Committee, my name is Thomas R. Anderson, Chief Executive Officer of Kemper Investors Life Insurance Company. I appreciate this opportunity to appear before you today to present the views of the Committee of Annuity Insurers on the tax treatment, at the company level, of variable annuity contracts under S. 1992. In particular, we wish to express our deep concern over the bill's continuation of the current double tax on capital gains allocable to nonqualified variable annuity contracts.

The Committee of Annuity Insurers, which consists of nineteen of the leading annuity writers in the insurance industry, was formed in 1981 for the purpose of monitoring legislative and regulatory issues affecting the annuity industry and annuity policyholders. A list of the member companies of our group is attached as Appendix A, along with a list of other companies supporting this statement.

Before turning to a discussion of the variable annuity issue, I would like to state that the Committee of Annuity Insurers urges this Congress to move expeditiously to enact permanent life insurance tax legislation. With the modification we are proposing today, S. 1992 will provide a viable framework for the taxation of life insurance companies, and therefore, we urge its prompt consideration by your Committee.

What Is A Variable Annuity Contract?

The variable annuity contract, like its forerunner the fixed annuity contract, has become an important instrument the company tax treatment of all other annuity and insurance products. Furthermore, this means that such gains will ultimately be taxed twice, since these amounts will be taxed once when realized by the separate account and once again at ordinary income tax rates when paid to policyholders.

Regretfully, Mr. Chairman, this tax treatment is preserved in S. 1992 (and Title II of H.R. 4170). Proposed new section 817 would continue to extract this double tax on variable annuity contracts, and, for the first time, would subject variable life contracts to this same tax treatment.

More specifically, under current law and S. 1992, insurance companies are generally allowed to deduct increases in their life insurance reserves. However, section 801(g)(6) of the Code[2/] (and proposed new section 817) denies any deduction for increases in life insurance reserves allocable to capital gain income attributable to variable annuity separate account assets. The statute goes on to tax any realized asset appreciation which gave rise to those reserves. Thus, the capital gain on nonqualified variable annuity contracts (and variable life contracts) is recognized and is taxed at the company

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[2/] Unless specified otherwise, all references to the Code will be to the Internal Revenue Code of 1954, as amended.

level.[3/] This treatment is entirely inconsistent with the treatment accorded to all other insurance products. Furthermore, when the policyholder receives payments under the variable annuity contract these same dollars are taxed again at ordinary income tax rates to the policyholder pursuant to the rules of section 72 of the Code.

It should be noted that, if the same company elected to invest the variable annuity premiums in assets giving rise to ordinary income rather than capital gains, no double tax would arise. We believe that, as a matter of tax policy, it should be irrelevant whether variable annuity premiums are invested in capital gain producing assets or ordinary income producing assets.

Mr. Chairman, we believe that this double tax is patently unfair. There can be no doubt that the variable annuity is an important instrument for responsible and conscientious taxpayers in the planning of their own financial security. It should not be taxed to the point where it cannot compete with other insurance and annuity products in today's market.

3/ Issuers of qualified variable annuity contracts are allowed under section 801(g)(7) of the Code to increase the basis of the separate account assets to reflect appreciation allocable to those assets. Hence, although issuers of qualified variable annuity contracts are denied deductions for increases in their reserves, they are not subject to capital gains tax on the appreciation necessitating those reserve increases.

In its report accompanying H.R. 4170, the House Committee on Ways and Means noted that they were retaining the current capital gains tax "in order to equalize tax treatment of insurance products based on investment funds and direct investment in such funds."[4/] A variable annuity is not, nor has it ever been, the same as a money market account or a mutual fund. Furthermore, while this market equality "justification" may have been accepted by some when the original provision was enacted, it is highly inappropriate today in light of the changes which were made in the tax treatment of annuities, including variable annuities, at the policyholder level in the Tax Equity and Fiscal Responsibility Act of 1983 ("TEFRA").

Prior to TEFRA, amounts received under an annuity contract before the annuity starting date were treated first as a nontaxable return of the policyholder's investment in the contract. Only after recovering all of the investment was the policyholder deemed to receive the taxable income earned under the contract.

In TEFRA, Congress made major changes in the tax treatment of annuities. The stated purpose of these revisions was to ensure that an annuity contract is used as a long-term retirement and savings vehicle, not as a short-term investment or "money market" type account. Specifically, in 1982, Congress reversed

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4/ H. Rept. No. 432, 98th Cong., 1st Sess., vol. I, page 122 (1983).

the tax treatment of "premature" withdrawals from the contract by treating such withdrawals as coming first from currently taxable income and then from the investment in the contract. In addition, with certain limited exceptions, a substantial penalty of five percent was imposed on withdrawals from an annuity contract prior to the earlier of ten years from the investment in the contract or age 59-1/2.

In S. 1992 additional restrictions -- on top of the TEFRA changes -- are being proposed. No longer will the penalty tax "wear off" with respect to investments that have remained in the contract for ten years. In addition, if a holder of an annuity contract has not annuitized the contract prior to death, the income on such contract will be taxed to the holder in his or her last return.

The TEFRA restrictions alone eliminate any concerns that variable annuities can directly compete with, much less enjoy a competitive edge over, mutual funds or other investment-based products. If any of the proposed restrictions in S. 1992 were to be finally adopted by the Congress, such an argument would become more tenuous. Thus, the continued imposition of an implicit penalty on variable annuity contracts by means of section 801(g)(6) is even more unwarranted today than it was when the section was originally enacted.

Proposed Modification To S. 1992

In order to eliminate this double tax, we propose that current section 801(g)(7) of the Code (proposed section for individuals in the planning of their own and/or their dependents' financial security.

Traditionally, annuity benefits have been expressed in terms of a fixed amount of dollars. Under such conventional or "fixed annuities," the value of the contract is guaranteed to be equal to the payments applied plus specified interest credits and less specified charges.

During the 1950's, the insurance industry began the marketing of variable annuities. In a variable annuity contract, each premium paid to the insurance company is placed in a "separate account" or "segregated asset account," the funds of which are invested by the insurance company in various equities and debt instruments. During the years prior to maturity, the value of the contract is not guaranteed, but rather will vary according to the investment performance of the separate account. At the distribution starting date, periodic payments are made which will vary with the investment experience of the accumulated funds.

Tax Treatment At Company Level Of Variable Annuity Contracts

Under current law, a tax is imposed at the company level on the capital gains realized by an insurance company even though they are credited to nonqualified variable annuity contracts.1/ Such treatment is directly contrary to

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1/ As is explained in Footnote 3, there is no similar tax on the insurance company in the case of qualified variable annuities.

817(d)(2)) be amended so as to apply to nonqualified, as well as qualified, variable annuity contracts. Thus, although companies would continue to be denied a deduction for increases in reserves allocable to separate account appreciation, they would be allowed, as is currently the case with qualified variable annuities, to adjust the basis of the separate account assets to reflect that appreciation, thereby eliminating the double taxation of capital gains. It should be noted that the gains on these variable annuity contracts would not escape taxation under our proposal. They would be taxed at ordinary income tax rates when distributed to the policyholder upon withdrawal or annuitization.

Furthermore, Mr. Chairman, the Committee of Annuity Insurers wishes to add its support to the proposal of the Investment Company Institute to modify Revenue Ruling 81-225, so as to permit variable annuity contracts to be based on publicly held mutual funds. The significant revisions made by TEFRA to the tax treatment of annuities under section 72 of the Code, coupled with any of the additional restrictions proposed in S. 1992, make Revenue Ruling 81-225 no longer necessary.

Reasons Why A "Basis Adjustment" Alternative Would Not Be Satisfactory

Mr. Chairman, we are aware that an alternative to our proposal to eliminate the capital gains tax at the company level has recently been suggested. Under this alternative, the corporate tax rate on capital gains under nonqualified variable annuities would be reduced from 28 percent to 20 percent, and the holder's basis in the contract would be increased by the amount of the gain taxed to the company. Although this "basis adjustment" alternative would remove the double tax, we believe that our proposal is far simpler to administer and, therefore, more in accord with sound tax policy.

Furthermore, no significant revenue is to be gained by the Government with the basis adjustment alternative as compared to our proposal. In fact, it appears that the alternative would produce revenue results that are substantially equivalent to (or possibly even less than) the complete elimination of the capital gains tax. Attached as Appendix B is a memorandum prepared by a member company of the Committee of Annuity Insurers which describes in detail the calculations of the revenue considerations of each proposal. I ask that this memorandum be made a part of the Committee record.

As explained in the enclosed memorandum, for variable annuity contracts surrendered within thirty years from issue, the overall tax generally would be lower under the "basis adjustment" alternative than under our proposal in the case of policyholders in the 30% to 50% income tax bracket. In other words, the U.S. Treasury stands to gain revenue under our proposal as compared to the alternative approach.

Revenue considerations aside, the Committee of Annuity Insurers strongly feels that elimination of the capital gains tax at the company level is preferable from an administrative point of view. Under the alternative approach, a company would be required to continually record and report basis adjustment data to its policyholders. Such reporting would be costly to the companies and undoubtedly confusing, if not incomprehensible, to the policyholders. Furthermore, it is questionable whether, in actual administration, the basis adjustment proposal would be fair and equitable from the standpoint of the policyholder. Under this alternative, the company presumably would allocate basis adjustments for realized gains among all the annuity policyholders coincident with the taxation of the gains even though some of those policyholders may not have been participating in the separate account throughout the time that the appreciation in the account actually occurred. In other words, individuals who purchased policies shortly before the allocation was made would share in the basis adjustment even though their premiums did not give rise to the appreciation that was taxed. In the brief time we have had to consider the basis adjustment alternative, we have concluded that it raises a number of additional technical problems as compared to our proposal.

In summary, when two proposals have essentially the same ultimate revenue impact, we strongly believe that the one that is the simpler to administer -- from the companies' standpoint -- the one that is easier to understand -- from the individuals' standpoint -- and the one that is easier to audit and enforce -- from the Government's standpoint -- should be the proposal adopted by this Committee. Thus, we urge the Committee to adopt our proposal.

Conclusion

Mr. Chairman, the annuity product has come to play an important role in our Nation's economy. For thousands of Americans of ordinary means, the annuity provides essential financial protection and security. Inflation and the increasing number of older citizens in this country have placed significant burdens on our Social Security system. For many, the variable annuity provides an essential supplement to public and private pension plans. For others, it provides the only source of income outside of Social Security in retirement years.

Rather than discouraging savings through variable annuity contracts via the company capital gains tax, we believe that Congress should act to encourage savings through such socially desirable consumer products.

In conclusion, the Committee of Annuity Insurers urges this Committee to amend S. 1992 so as to eliminate the capital gains tax at the company level on nonqualified variable annuities. The current double tax is patently unfair and is unwarranted. In closing, we also wish to endorse the proposal by the Stock Company Information Group and other industry witnesses to eliminate the proposed capital gains tax on variable life insurance contracts.

STATEMENT OF EDWIN S. COHEN, COVINGTON & BURLING, WASHINGTON, D.C., ON BEHALF OF INVESTMENT COMPANY INSTITUTE, WASHINGTON, D.C.

Senator CHAFEE. Mr. Cohen.

Mr. COHEN. Thank you, Mr. Chairman.

I am appearing before the committee this morning on behalf of the Investment Company Institute, which is the national association for the mutual fund industry. I would say to the committee that the institute would support the repeal of the capital gains tax on variable annuities if at the same time the Congress would overturn Revenue Ruling 81-225, which was referred to earlier.

That ruling held that the income tax rules relating to variable annuities would not be applicable if the insurance company's segregated asset account invests in the shares of a mutual fund that offers it shares to the public. In that event, the holder of the variable annuity contract, according to the IRS ruling, would be treated as though he himself owned the mutual fund shares rather than those shares being owned by the insurance company.

On the other hand, if the mutual fund does not offer its shares to the public, but offers them only to segregated asset accounts and insurance companies, then the annuity rules would apply.

The practical effect of this ruling has been to create an unwarranted and unnecessary division within the mutual fund industry, between those mutual fund sponsors that are affiliated with an insurance company and those that are not so affiliated. The affiliated companies, as a practical matter, are able to offer to the public either variable annuities or mutual fund shares. But the independent mutual fund sponsor has found that it cannot do so under the present circumstances.

Secretary Chapoton, as I understood him, acknowledged this unfair circumstance today. We would point out that if this distinction were to continue, the tax law would have a tendency to provide a reason for mergers of mutual fund sponsors with insurance companies in order that they could offer both products. And the Substitute believes strongly that it would be a most unfortunate circumstance for the tax law to tend to favor concentration in the industry.

[The prepared statement of Mr. Cohen follows:]

STATEMENT OF
EDWIN S. COHEN
ON BEHALF OF
THE INVESTMENT COMPANY INSTITUTE
CONCERNING THE TREATMENT OF VARIABLE CONTRACTS
UNDER S. 1992 -- THE LIFE INSURANCE TAX BILL OF 1983
BEFORE
THE COMMITTEE ON FINANCE
UNITED STATES SENATE
JANUARY 31, 1984

My name is Edwin S. Cohen. I am a partner in the law firm of Covington & Burling, Washington, D.C. I appear before the Committee today on behalf of the Investment Company Institute. The Institute is the national association for the American mutual fund industry. Its members include some 900 open-end investment companies ("mutual funds"), their investment advisors and principal underwriters.

Mutual funds are investment companies that offer their shares to investors and invest the funds received in diversified portfolios as required by the Investment Company Act of 1940. Mutual funds were developed more than 50 years ago as a means of permitting the pooling of investment funds to secure diversification of risks and professional investment management. Today the Institute's members have assets totaling approximately $265 billion and have approximately 16 million shareholders.

The insurance industry has proposed that segregated asset accounts be relieved of capital gains taxation. The Institute believes that the resulting new tax framework for variable annuity contracts under this proposal should include a further revision generally permitting mutual funds to be utilized as funding media for the segregated asset accounts. Today, Revenue Ruling 81-225 operates to deny mutual funds whose shares are made available to the public for investment the opportunity to serve as funding media for variable annuity contracts. The Institute believes, for the reasons discussed in this Statement, that this policy is unwise and unfair to the excluded mutual fund companies as well as to the consuming public and that the Congress should undertake to reverse the consequences of Revenue Ruling 81-225.

Thus the Institute would support the elimination of the capital gains tax on variable annuities if at the same time Congress overturns Revenue Ruling 81-225 and permits mutual funds to be used as the funding media for variable annuities whether or not the mutual funds' shares are publicly offered.

I. Public Availability of Mutual Fund Shares Is an Inappropriate and Unncesssary Standard by Which to Determine the Taxability of Variable Contractholders.

Individuals owning variable annuity contracts are not subject to income tax on interest and dividends received in the segregated asset account supporting the annuity as well as capital gains realized in the segregated asset account until those amounts are actually distributed to the individuals. The interest and dividend income accumulating in the segregated asset account are not taxed to the insurance company issuing the contract, but capital gains realized in the segregated asset account are currently taxed to the insurance company. Prior to Revenue Ruling 81-225, this pattern of taxation applied regardless of whether the segregated asset account maintained its own portfolio of securities or invested in the shares of a mutual fund.

Mutual funds, on the other hand, are subject to taxation on dividends and interest as well as capital gains realized unless those amounts are currently distributed to their shareholders. Thus mutual funds currently distribute their income, including dividends, interest and capital gains, less expenses of operation, to their shareholders, and accordingly, the shareholders are currently taxable on these amounts.

Revenue Ruling 81-225, which was issued September 25, 1981, before the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), took the position that a variable annuity contract would not be treated by the Internal Revenue Service as governed by the income tax rules relating to annuity contracts if the segregated asset account invested shares of a mutual fund that are available for purchase by individuals. If the segregated asset account were to invest in shares of a mutual fund that are publicly available for purchase, then the individual owning the variable annuity contract would be treated for federal income tax purposes under the Revenue Ruling as though he owned directly the mutual fund shares held by the insurance company, and hence he would be currently taxable on income distributed by the mutual fund. However, if the mutual fund shares are available for purchase only by segregated asset accounts (or if the segregated asset account holds its own portfolio of securities) then the income tax rules relating to annuity contracts are applicable and the individual is not currently taxable.

This position was taken by the Service before the enactment of TEFRA, which materially altered the income tax rules relating to annuity contracts, including the imposition of a penalty tax of 5 percent on income prematurely withdrawn by the holder of the contract. Despite the penalty tax now provided, the Service has not altered its position that the holder of an annuity contract is currently taxable as though he owns the mutual fund shares purchased by the segregated asset account if they were available for direct purchase by the public but not if the shares were available for purchase only by segregated asset accounts. The pending bill, S. 1992, would lengthen the period during which the penalty tax would be applicable.

The segregated asset account is subject to the Investment Company Act of 1940 and the Securities Act of 1933 whether it maintains its own securities portfolio or invests in shares of a mutual fund. Under those laws it is immaterial whether the mutual fund shares are publicly available or are offered exclusively to one or more segregated asset accounts. Under these laws the critical common element in all such circumstances is that the individual has given to others the power and discretion to select the particular securities in which the funds are to be invested. The investment managers of the mutual fund (or the investment managers of the insurance company where the segregated asset account has its own securities portfolio) have the responsibility for investment selection, not the individual holding the variable annuity contract. The individual does not control the investment selection, whether or not the mutual fund shares are publicly available. The essential similarity of the contractholder's position with respect to the investments underlying the annuity contract demonstrates the illogic of the distinction drawn in Revenue Ruling 81-225.

The operative premise of Revenue Ruling 81-225 is that direct investment in shares of a mutual fund and ownership of a variable contract funded through shares of the same mutual fund are interchangeable forms of investment. There are important differences, however, between the legal rights and consequences attendant upon ownership of a variable annuity contract and direct ownership of mutual fund shares:

1. The variable annuity contractholder has a guarantee of mortality tables which protect him against longevity and for which he is charged a premium by the insurance company.

2. Under many state laws the variable annuity contract, like fixed annuity contracts, is not subject to attachment or levy by creditors.
3. Variable annuity contracts are subject to regulation by state insurance commissioners and subject to state premium taxes.
4. In the event of death the rights of the variable annuity contractholder pass under state law to the beneficiary named in the contract and is not subject to administration by his executor.

In addition there are significant differences in federal income tax treatment of the mutual fund shareholder and the variable annuity contractholder, beyond those referred to earlier, both during his lifetime and at death. Capital gains realized by a segregated asset account are taxed as ordinary income upon distribution whereas the character of capital gains realized by a mutual fund is passed through to the shareholder. Although the value of mutual fund shares and variable contracts are both includible in the gross estate for estate tax purposes, the basis of mutual fund shares after death is their market value at the time of death, but the basis of a variable annuity contract does not change at death and the provisions of Code section 691 are applicable. Further, while an exchange of shares in one mutual fund for shares in another gives rise to recognized gain or loss, Code section 1035 permits a tax-free exchange of one variable annuity contract for another variable annuity contract.

The differing tax and legal consequences of purchasing a variable annuity contract as opposed to direct investment in mutual fund shares are ample to assure that individuals with short-term investment objectives will not choose to purchase variable annuity contracts in lieu of direct investment in mutual fund shares merely to avail themselves of the tax deferral associated with variable annuity contracts. Notwithstanding these differences and, in particular, the enactment of TEFRA subsequent to the publication of Revenue Ruling 81-225, the Internal Revenue Service has not altered its position in Revenue Ruling 81-225 against the utilization of publicly-available mutual funds as funding media.

II. Revenue Ruling 81-225 Has Created An Unwarranted Division Within the Mutual Fund Industry.

Over the years some companies that manage mutual funds and offer their shares have organized or acquired life insurance companies that offer variable annuities. Some life insurance companies offering variable annuities have organized or acquired management companies that offer mutual funds to the public. Some holding companies own life insurance company subsidiaries and management company subsidiaries. If there is a public market for variable annuity contracts, the supply for that market will be furnished by one or more combinations of these various organizations that will simply be forced to conform to the precise form of organization that might be dictated by the IRS and the Treasury.

The unfortunate effect of Revenue Ruling 81-225 has been to create a sharp division within the mutual fund industry. Where mutual fund sponsors are affiliated with life insurance companies, the affiliated group can offer to the public the choice between mutual funds shares and variable annuities. But where they are not so affiliated, as a practical matter Revenue Ruling 81-225 prevents mutual fund sponsors from joining with unaffiliated life insurance companies to offer a variable annuity. Since many mutual fund organizations are affiliated with insurance companies and many are not, the result has been to draw an irrational line advantaging some companies and disadvantaging others in a highly competitive industry.

This distinction is especially objectionable where the proffered rationale rests on an increasingly blurry line. As stated above, mutual funds are subject to the same registration requirements and regulatory constraints whether they are publicly available or dedicated to a segregated asset account of an insurance company. In both circumstances it is the investment manager that is responsible for the investment results of the mutual fund. The predictable consequence of the existing division in the industry is that companies that market variable annuities have increasingly included in their marketing strategy promotion of the investment performance record of the dedicated mutual fund that serves as the funding medium for the segregated asset account. This development is best illustrated by the trend of changing the names of the dedicated mutual funds from nondescript names, such as Variable Account A, to names that are intended to draw the purchaser's attention to the investment performance of the mutual fund. Examples of such names include references to "capital growth", "high yield" and "capital accumulation." These names are indistinguishable from those of publicly-available mutual funds. As these dedicated funds develop their own identities and performance records, the investment considerations posed to the potential purchaser of a variable annuity contract will be indistinguishable from the situation that would exist if publicly-available funds were utilized as the funding media of segregated asset accounts. The Institute thus believes that the distinction created by Revenue Ruling 81-225 between publicly-available mutual funds and "captive" mutual funds is unwarranted and without sound basis in policy or fact.

III. Revenue Ruling 81-225 Unjustifiably Deprives The Consumer Of The Freedom Of Choice Of Funding Media.

Given the essential similarity of mutual funds that may serve as funding media for variable contracts and mutual funds that under Revenue Ruling 81-225 may not do so, Revenue Ruling 81-225 has the perverse effect of permitting a variable annuity contract purchaser to continue to select a contract with a funding medium that comports with the purchaser's investment objectives but limits that choice to funds that are affiliated with insurance companies. The practical consequence of this is, to deny purchasers the freedom to purchase variable annuity contracts funded by mutual funds that have remained independent. As a paractical matter, it has also deprived purchasers of the opportunity to buy variable annuity contracts from insurance companies that are too small to manage a portfolio in their segregated asset accounts or to acquire a captive mutual fund. Furthermore, the ability of independent mutual funds with good, long-term performance records to enter into contractual relationships with insurance companies to serve as funding media for variable contracts has been foreclosed. The Investment Company Institute believes that these restrictions on the investing public are unwarranted and tend to discourage rather than to encourage saving and investment by the American public.

IV. Conclusion.

It is submitted that properly analyzed there is not a shred of evidence that the Congress intended that a variable annuity must represent an interest in investments that are not available for direct purchase by the public or that such a requirement would have any material effect on the market for variable annuities. Indeed, the validity of the conclusions expressed in Revenue Ruling 81-225 are currently being tested in litigation in court. There is thus the real prospect of repeated litigation of this issue, raising the spectre of inconsistent results and prolonged uncertainty as to the proper tax treatment of variable annuity contracts. The uncertainty in the area is compounded by the recent issuance of rulings guidelines by the Internal Revenue Service as to which types of variable annuity contracts will qualify as such. Thus, Revenue Ruling 81-225 and the events surrounding its publication have created confusion rather than clarity without providing any discernable benefit to the public or to the revenues. Revenue Ruling 81-225 serves to increase the concentration and combination of managers of mutual funds and insurance companies and to introduce the need for hair-splitting decisions by the Internal Revenue Service as to the meaning of "publicly available."

The Institute believes that distinctions based upon whether management is provided by the employees of an insurance company or one of its mutual fund affiliates or by the employees of an unaffiliated mutual fund produces as a practical matter a variety of discriminatory competitive results without any practical benefit to the public or to the government. Accordingly, the Institute believes the creation of a new tax framework for variable insurance contracts should include provisions permitting mutual funds generally to be utilized as funding media for such contracts.

Senator **Chafee**. What would be your answer if we didn't repeal that revenue ruling?

Mr. **Cohen**. I have instructions from the Board of Governors of the Institute that the institute would support the repeal of the capital gains tax on seperated asset accounts if Revenue Ruling 81-225 were to be overruled. I have no instructions beyond that, and no vote has been taken because it is a divisive matter, Mr. Chairman, within the industry, and it would just pit one group in the industry that is affiliated with the insurance companies against another group that is not affiliated.

Senator **Chafee**. I see.

Let me ask a question of Mr. Anderson. You heard the Secretary's testimony here, and he backed off, it seemed to me, on the taxation of the variable life insurance, but on the annuities he stood firm. What answer do you have to his statement that if we eliminated the tax as you have reguarded, then the tilt would be the other way, that is against the mutual funds.

Mr. **Anderson**. Well, I disagree. First of all, I think the tilt is definitely against the insurance companies who underwrite variable annuities because there clearly is a double taxation. You can ask anybody on the street who is trying to sell both products. At Kemper we have individuals who sell both products side by side. They are sold for different reasons. But clearly the tilt is against insurance companies right now because of this double taxation issue. And I would argue very strenuously that it will be relatively balanced if you do away with this company capital gains tax. In the case of mutual fund, you have a current investment that is taxable currently. However, the investor has all the liquidity he wants. He has full control of his investments. He can have that money any time he wants. And he also has the benefit of the lower capital gains tax—in lieu of the ordinary tax rate—when the funds realize capital gains.

The annuity policyholder on the other hand, pays a severe penalty, in my opinion, since TEFRA. This act before us is even strengthening that penalty by extending the period of time over which that penalty tax is paid. An annuity purchaser does not have liquidity. And he is going to in the final analysis also pay tax at ordinary income rates. He does not have that liquidity—that is the price he is paying for that tax deferral.

Senator **Chafee**. Senator Packwood.

Senator **Packwood**. No questions.

Senator **Chafee**. Senator Bentsen.

Senator **Bentsen**. Well, it seems to me that we ought to be encouraging insurance companies to buy, whether it is bonds or stocks, those things that give us the most security and the best return. And that the tax system really ought to be neutral in that regard. But it's not. In this situation we are seeing capital gains being taxed at a higher rate than ordinary income. And for anyone to say that equity is something that will give you a great deal more risk, I can recall one time participating in the buying of a life insurance company that had some Los Angeles municipals maturing in the year 2010, yielding 1 percent. And you can imagine what the face value of those bonds were. So I think once again that we ought to be trying to see that we have a revenue neutral system taxwise.

And to end up with double taxation on capital gains really is not equitable.

Mr. ANDERSON. I agree totally, Senator. I think it's totally illogical and counterproductive for our tax law to provide a disincentive for equity investment in this country. It just makes no sense.

Senator CHAFEE. Well, we certainly want to congratulate the municipal finance officer from Los Angeles who peddled those bonds. [Laughter.]

Senator CHAFEE. Senator Dole.

The CHAIRMAN. I just have a couple of questions. Mr. Anderson, you mentioned in your testimony on page 6 that restrictions on the use of annuity contracts distinguished variable annuities from investments in mutual funds. Can I assume from that that you support the annuity provisions of the bill?

Mr. ANDERSON. The regular annuity provisions, Senator? Yes, we do.

The CHAIRMAN. And I think also we may be in general agreement on this committee that the provisions of the House bill are somewhat harsh. And I think it's also true that the present law is too generous since a company has to pay a tax on gain on capital gains rate on the sale of securities and a segregated asset account would get to take a deduction against ordinary income for an increase in reserves to satisfy the increased obligations to a customer. I think somewhere in there we may be able to figure out a better way.

Mr. GARBER. With respect to both variable life and variable annuities, Senator, the proposal that has been put forward is to net the reserve deduction against the realized gain so that doesn't happen. Thus they are both essentially at the same rate.

Senator CHAFEE. Senator Symms.

Senator SYMMS. No questions, Mr. Chairman.

Senator CHAFEE. Don't we see advertisements for variable life insurance contracts that emphasize the ability of the variable contract holder to tie the policy earnings to the performance of the stock market?

Mr. MORTON. You probably are looking at our advertisements, Senator. I'm glad they caught your attention. [Laughter.] We have advertisements which certainly emphasize the flexibility as to overall investment strategy that the policyholder has under a variable life policy. That is a unique feature of a variable life contract. I think that's what you will find referred to in the headlines of those advertisements.

As you read the advertisements, you will find that each is an advertisement for a life insurance policy. That was our intention. That's the way it's sold. That's what our insurance salesmen believe it is, and that's what the customer believes it is and is what we advise them.

Senator CHAFEE. All right. Fine. Thank you very much, gentlemen. We appreciate it.

The next panel will be Dr. Chasey, Mr. Perrin, Mr. Holden, and Mr. Eizenstat.

Gentlemen, we welcome you here. Let's begin with Dr. Chasey.

STATEMENT OF DR. WILLIAM C. CHASEY, PRESIDENT AND EXECUTIVE DIRECTOR, AND JOHN D. REGAN, DIRECTOR, LIFE INSURANCE COALITION OF AMERICA, WASHINGTON, D.C.

Dr. **Chasey**. Thank you, Mr. Chairman.

My name is Bill Chasey, and I'm president of the Life Insurance Coalition of America. LICA, as it is better known, is a nonprofit Washington-based organization that represents the interest of millions of policyholders of America.

We are in a unique position this morning in that we are not a party to any compromises made at this point, and will probably say some of the things that many of those who are part of the compromise would like to say, but can't say.

I'm going to turn the program right now to Mr. John Regan and Mr. Bud Smith who are board members of LICA who will finish the testimony.

[The prepared statement of Dr. Chasey follows:]

TESTIMONY OF THE LIFE INSURANCE COALITION OF AMERICA

ON SENATE BILL 1992

CONCERNING

THE POLICYHOLDER PROVISIONS OF THE LIFE INSURANCE TAX ACT OF 1983

SENATE FINANCE COMMITTEE

I am Dr. William C. Chasey, President and Executive Director of the Life Insurance Coalition of America ("LICA"). LICA is a Washington based non-profit organization that has been formed to represent the interests of the millions of policyholders and consumers of life insurance products before the Congress. I am here today to testify on behalf of these consumers in connection with your consideration of certain provisions of S. 1992, the Life Insurance Tax Act of 1983. LICA strongly believes that the so-called policyholder provisions that appear in Subtitle B of Title I of S. 1992 will adversely impact the individual consumer of life insurance products if enacted. My testimony will be directed at these policyholder provisions. Specifically, I will comment on the proposed definition of life insurance contract set out in Section 221 of Subtitle B, the proposed change in the treatment of certain annuity contracts set out in Section 222 of Subtitle B, the proposed interest deduction cap on financed life insurance set out in Section 223 of such subtitle, and the proposed tax on retirees participating in group term life insurance programs, such tax being provided for in Section 224 of Subtitle B.

DISCUSSION

First and fundamentally, it appears that to date the focus of this Committee and the House Ways & Means Committee has been on Subtitle B's impact on companies and agents. This focus unfortunately does not address the interests of an important group of individuals, namely, insurance policyholders and the consumers of life insurance products. LICA believes that enactment of the policyholder taxation proposals will result in the elimination of life insurance and retirement protection currently afforded many individuals. For this reason, we urge this Committee not to move in haste and make changes that may have unknown, far reaching effects on the consumer. There are significant policy considerations that demonstrate that the provisions of Subtitle B of S. 1992 (other than perhaps the proposed definition of life insurance contract) do not make good tax or economic sense for life insurance consumers, and LICA consequently feels that the Congress will be making a serious policy error if it enacts these provisions. These policy considerations will be explored more fully throughout this testimony. LICA also believes that the Subtitle B provisions do not make good tax or economic sense for our country, because to date no study has shown that the Subtitle B proposals will produce revenue for our treasury. LICA submits that the provisions of Subtitle B will have one certain result if they are enacted — consumers will purchase less life insurance and thereby obtain less protection against the certainty of death, life insurance companies will receive less premiums as the result of fewer consumer purchases, thereby affecting their ability to perform their traditional role in fostering the formation of capital in our economy, and the Internal Revenue Service will receive less taxes from these companies as a result of the decrease in premium dollars received. LICA believes that Subtitle B's provisions are in fact revenue losers rather than revenue winners, and LICA therefore submits that it is unthinkable for the Congress to enact a statute resulting both in adverse consumer impact (through loss of insurance protection) and loss of tax revenues. With these general comments in mind, I now turn to a detailed examination of each provision of Subtitle B.

LICA believes the proposed definition of life insurance contract set out in Section 221 of Subtitle B goes a long way toward eliminating perceived abuses, and, with one exception, LICA supports the new definition in principle. However, because the jury is still out on the industry and consumer impact of the changes made in this area by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), LICA thinks it is premature to take additional action now to tighten further the rules that determine what are and are not life insurance contracts for tax purposes. The one exception that LICA takes to Section 221 involves the cash value corridor concept described in Section 221(d). As presently drafted, future increases in death benefits (e.g., for cost-of-living riders) are not to be considered in assessing whether the cash value corridor test has been satisfied. LICA believes that this approach ignores the reality of our inflationary environment. The cash value corridor concept must be changed to allow consumers to increase their insurance coverage under a policy as inflation requires additional liquidity protection.

Section 222 of Subtitle B will increase the instances in which penalties are imposed in connection with distributions from annuity contracts, and will subject the cash value of an annuity contract to income tax if the holder of the contract dies before the annuity starting date. Senator Bentsen has already voiced his reluctance to enact the changes proposed in Section 222 without further study, and LICA wholeheartedly joins with Senator Bentsen in this concern. However, LICA would go further and urge this Committee to bear in mind the fact that any increase in the instances in which penalties are assessed in connection with distributions from annuity contracts is bound to diminish their attractiveness as savings vehicles for retirement, thereby denying some consumers a traditional low risk means of insuring adequate retirement income protection. The "deemed distribution on death" provision of Section 222 also seems unwise from a policy perspective because the cash lost through the imposition of additional taxes at time of death will be lost to widows or widowers who may then have need for every penny they can get. For the reasons just described, LICA cannot support Section 222, especially when it is viewed from the vantage point of the insurance consumer.

Section 223 of Subtitle B would cap the amount of interest deduction available with respect to certain policy loans, and, if enacted, will have a devastating impact on the use of life insurance products to provide consumers with adequate retirement and death benefits. Representatives of the insurance industry may have told you that Section 223 will not adversely disrupt the insurance marketplace if enacted. A study that LICA has carried out indicates that this is simply not true. A 35 year old male who buys financed life insurance protection under Section 223's rules can find that at age 64 no interest deduction will be available with respect to policy loans, and he then will be faced with two choices — either continue purchasing the policy without the benefit of any interest deduction or surrender the policy for its cash value and bear the tax consequences that flow from surrender. The truth of the matter is that if our hypothetical 35 year old knows that no interest deduction will be available at age 64, he simply will not buy the policy. As noted earlier, if the policy is not purchased, the potential issuer loses premiums that would otherwise generate taxes needed to run our government. In addition, if financed life insurance is curtailed, many businessmen, particularly the small, closely-held entrepreneur, will be unable to afford the coverage needed to insure that their businesses can survive their death, and terminated businesses will result in lost jobs and removal of capital from the market place. Healthy, prosperous businesses are clearly key to insuring that our nation solves its terrible budget deficit crisis, and LICA believes that financed life insurance can play an important role in preserving healthy businesses, particularly in the case of the small businessman.

Several other points need to be made in connection with your consideration of the interest deduction cap proposed in Section 223 of Subtitle B:

1. The proposed changes to the definition of life insurance contracts, discussed above, will insure that products made available to consumers are in fact life insurance vehicles as opposed to mere investment contracts. LICA believes that if these changes are enacted, any further limitation on policy loan interest deductions is simply not needed.

2. Some have argued that a deduction for interest paid with respect to a life insurance loan is inappropriate because the loan is made against cash values that earn income tax-free. This point of view ignores the reality that substantial taxes are raised at the life insurance company level through the sale of cash value policies, and these taxes will presumably become even more substantial if the company portions of Subtitle A of S. 1992 are enacted.

3. The imposition of a special interest deduction limitation on life insurance policy loans discriminates against this area of our capital formation markets without any similar limitations being placed on other capital formation techniques. For example, corporations can borrow against the security of their dividend-bearing stocks, where 85% of their dividend income is received tax free, but no interest deduction limitations are imposed on these corporations with respect to such borrowings. In addition, the tax-free nature of the death proceeds received under a life insurance policy is similar to the capital appreciation basis step-up on assets held at time of death. Yet interest deductions are not disallowed with respect to a residential mortgage, even though any unrealized income on the residence essentially disappears at death.

4. Section 264 of the Internal Revenue Code of 1954 ("Code") already imposes special limitations on life insurance policy loans that are not applied to any other form of borrowing. LICA believes that Section 264 should be repealed and while it exists, it is

even more inappropriate to introduce further discrimination against life insurance loans into the Code.

5. LICA believes that the interest deduction cap will cause a substantial lapse in existing permanent life insurance coverage and discourage the purchase of new permanent life insurance. The possibility that Subtitle B's provisions might become law has already caused some consumers not to make purchases of life insurance, on the theory that if Congress does this today, who knows what it may do tomorrow. LICA understands that purchases of certain cash value and group insurance policies are down in the last quarter of 1983 from 25% to as much as 40% primarily due to concern over Subtitle B's policyholder provisions. LICA submits that any limitation on financed life insurance will inhibit consumer purchases of needed insurance. Declining purchases in the face of the threat of Subtitle B offer proof of that fact.

6. The concept of a cap on interest deductions for financed life insurance purchases ignores the fact that individuals customarily purchase additional coverage from time to time as inflation changes future liquidity needs. In addition, coverage is often increased to protect against uninsurability in old age or the higher premium cost associated with purchases of insurance at that time, even if insurability is not in issue. Section 223 thus ignores the reality both of our economy (inflation) and of our insurance market place (consumer incentives to purchase insurance today to avoid excessive future cost).

7. One stated purpose of S. 1992 is to raise revenue for the federal government to help reduce the extensive budget deficits our country is facing. LICA believes that federal budget deficits must be addressed. However, as noted earlier, LICA believes that the interest deduction cap proposed in Section 223 will in fact result in a revenue loss to the Treasury rather than a gain. Again, fewer policies will be purchased with the interest deduction cap in place, a lesser amount of premiums will be paid to companies, and less tax will thus be paid by these companies to the federal government with respect to policies actually purchased. We think this fact alone should settle the argument over the propriety of an interest deduction cap.

For the reasons set out above, LICA believes the interest deduction cap proposed in Section 223 is an idea whose time will never come. The concept of the cap may be fine for some agents and companies, but it will have a disastrous effect on the consumer because he or she (particularly the small business man or woman who is trying to implement an estate plan to insure the survival of their business) will not purchase insurance in amounts needed for adequate protection. LICA thus cannot support Section 223 in any form.

Section 22 4 of Subtitle B would dramatically change the rules associated with the provision of life insurance benefits to retired employees. LICA believes that this change should not be made for the following reasons:

1. TEFRA has already imposed tougher tax qualification standards on group life programs, and the impact of these new standards on the continued maintenance of such programs needs to be evaluated before any additional changes are made to the area.

2. The Uniform Premium Rate Table (Table I) under Code section 79 was recently reduced for the first time in 18 years. The rate reduction — 28% — ignored the fact that industry mortality costs were down 60-70% over the old Table I rates. In addition, the $50,000 coverage exclusion in Code section 79 has not been increased to reflect inflation. LICA believes the Congress should act to bring Table I into conformity with actual industry experience and raise the $50,000 exclusion now granted under Code section 79. If these changes are not forthcoming now, Congress should not introduce any further restrictions into a statute that is already suffering from a healthy dose of unreality.

3. Group life insurance programs are increasingly becoming a cornerstone in employee benefit planning, and the imposition of anti-discrimination standards on retired employees may cause the cancellation of group life programs and consequent loss of benefits to employees.

4. An added tax on retirees may cause retirees to reduce coverage in order to avoid the additional tax, thereby creating a gap in insurance coverage for the group of people who need it the most.

5. It is an unwise policy to create a new tax on retired employees with respect to the provision of life insurance benefits for their retirement years at a time when these same retired employees are concerned about the ability of the Social Security system to continue to provide them with an adequate level of retirement income.

6. The changes proposed in Section 224 would have the effect of punishing retired employees by subjecting them to taxation due to actions of their ex-employers, actions over which they have no control. For example, an employer might intentionally or unintentionally violate the Code section 79 anti-discrimination rules. The retired employee would have no control over the employer's actions, but suddenly the retired employee gets a Form 1099 in the mail saying additional income is reportable on his or her tax return. LICA believes that this situation will create an administrative dilemna for the government because the retired employee will not understand what has been received and will likely ignore the obligation to report additional taxable income, thereby rendering the Section 224 provisions unenforceable and fiscally irresponsible.

LICA believes that the changes proposed in Section 224, if enacted, will be unpopular with all consumers, will do nothing to help solve our nation's budget deficits and will end up being the most severely criticized provision in the legislation, probably requiring subsequent revision or repeal.

CONCLUSION

LICA is before you today representing the interests of life insurance consumers, individuals whose interests have not been adequately considered during the development of the proposed changes for taxing life insurance companies and life insurance products. The changes proposed in S. 1992 in the area of taxation of life insurance products are much more far-reaching than they may seem to be on their face, and we urge this Committee to remove the policyholder provisions from S. 1992. LICA is concerned and believes that the proposed changes will be counterproductive to making life insurance products available to consumers at levels that are needed for adequate retirement and death protection. Life insurance has fulfilled an important social policy goal in this country, namely, the protection of individuals and loved ones following retirement or death. Changes that would dramatically impact the ability to meet this social policy goal must not be made, or individuals, not just life insurance companies or life insurance agents, will suffer. For the reasons set out in this testimony, LICA urges that the entirety of Subtitle B (with perhaps the exception of Section 221) be stricken from Title I of S. 1992.

STATEMENT OF JOHN D. REGAN, BOARD MEMBER, INSURANCE COALITION OF AMERICA, WASHINGTON, D.C.

Mr. REGAN. Mr. Chairman, my name is John Regan, a LICA board member. LICA is concerned that deliberations in this committee and in the House Ways and Means Committee focus primarily on life insurance companies and agents and have ignored the needs and interests of the life insurance policyholders.

LICA believes the enactment of the policyholder taxation proposals will result in the elimination of life insurance and retirement protection currently afforded many individuals. There are significant policy considerations that demonstrate the provisions of subtitle B of S. 1992, with perhaps the exception of the proposed definition of life insurance contracts, do not make good tax or economic sense for the life insurance consumers. And LICA consequently feels that the Congress will be making a serious policy error if it enacts these provisions.

LICA also believes that the subtitle B provisions do not make good tax or economic sense for our country because to date, as confirmed by Mr. Chapoton, no study has shown that the subtitle B proposals are revenue producers.

LICA submits the provisions of subtitle B will have disastrous results if they are enacted. Consumers will purchase less life insurance, and thereby obtain less protection against the certainty of death, life insurance companies will receive less premiums as a result of fewer consumer purchasers, thereby affecting their ability to perform their traditional role in fostering the formation of capital in our economy. And the Internal Revenue Service will receive less taxes from these companies as a result of the decrease in premium dollars received.

LICA believes the subtitle B provisions are, in fact, revenue losers rather than revenue winners. And LICA, therefore, submits that it is unthinkable for the Congress to enact a statute resulting in both adverse consumer impact through loss of the insurance protection, and loss of tax revenues.

With these general comments in mind, I now turn to a brief examination of each provision of subtitle B.

No. 1, LICA believes the proposed definition of life insurance contract set out in section 221 of subtitle B goes a long way toward eliminating perceived abuses. And with one exception LICA supports the new definition in principle. The one exception the cash value corridor concept described in section 221(b). As presently drafted, future increases in death benefits—that is for automatic cost-of-living riders for example—are not to be considered in assessing whether the cash value quarter test has been satisfied. The cash value corridor concept must be changed to allow consumers to increase their insurance coverage under a policy as inflation requires additional liquidity protection.

Senator CHAFEE. Now, Mr. Regan, you've got to move along a little faster. You have exceeded your time.

Mr. REGAN. All right. Should I talk faster?

Senator CHAFEE. Well, better to abbreviate.

Mr. REGAN. All right.

Senator CHAFEE. Don't object so much to the points maybe.

Mr. REGAN. All right. Section 222 of subtitle B will be discussed, I think, by some of the other people here on the panel so I will pass on that one.

Section 223 of subtitle B would cap the amount of interest deduction available with respect to certain policy loans. Representatives of the insurance industry have told you that section 223 will not adversely disrupt the insurance market place if enacted. It has. It's not the dollar amount. It's the principle. Informed consumers are afraid to purchase traditional cash value products today.

LICA understands purchases of certain cash value and group policies are down 25 to 40 percent in the last 3 months of 1983. That cuts company revenues, tax revenues, and many businessmen, particularly the small businessman, the closely held entrepreneur, will be unable to afford the coverage needed to insure that their businesses can survive and continue.

As stated before, the proposed definitions of life insurance contracts will insure the products made available to consumers are, in fact, life insurance vehicles as opposed to mere investment contracts.

Section 264 of the IRC already imposes special limitations on life insurance policy loans that are not applied to any other form of borrowing. LICA believes 264 should be repealed to achieve equity. While it exists, it is even more inappropriate to introduce further discrimination against life insurance loans into the code.

LICA believes the interest deduction cap will lead to substantial lapses in existing permanent life insurance coverage. One stated purpose of S. 1992 is to raise revenue for the Federal Government. We believe it will be a revenue loser.

Finally, turning to section 224 of subtitle B, which would radically change the rules associated with the provision of life insurance benefits to retired employees, LICA believes this change should not be made. The uniform premium table under code section 79 was recently reduced as directed by Congress in the 1960's for the first time in 18 years. That rate reduction, approximately 28 percent, ignored the fact that industry mortality cost and cost for individual term insurance with full commission loads were down 60 to 80 percent over the old table one rates. In addition, the $50,000 coverage exclusion in code 79 has not been increased to reflect inflation since 1964. LICA believes the Congress should act to bring table 1 into conformity with actual cost and industry experience, and adjust the $50,000 exclusion now granted under 79 for inflation.

If these changes are not forthcoming now, Congress should not introduce any further restrictions into a statute that is already suffering from a healthy dose of unreality. An added tax on retirees with no corresponding additional dollars to pay the tax, may cause retirees to unwittingly cancel or reduce coverage in order to avoid the additional tax, thereby creating a gap in insurance coverage for the group of people who need it the most. The changes proposed in 224 would have the effect of punishing retired employees by subjecting them to taxation due to actions of their exemployers, actions over which they have no control.

In conclusion, life insurance has filled an important social policy goal in this country; namely, the protection of individuals and loved ones following retirement or death. Changes that would dramatically impact the ability to meet this social policy goal must not be made or individuals and the Treasury—not just life insurance companies or life insurance agents—will suffer. LICA therefore urges that the entire subtitle B, with perhaps the exception of 221, be stricken from title 1 of S. 1992.

Senator CHAFEE. Outside of that, you are firmly for the bill, I gather.

Mr. REGAN. Correct.

Senator CHAFEE. Mr. Perrin.

STATEMENT OF GEORGE PERRIN, MANAGER, BENEFITS PLANNING AND DEVELOPMENT, EASTMAN KODAK CO., ROCHESTER, N.Y., ON BEHALF OF ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, WASHINGTON, D.C.

Mr. PERRIN. Mr. Chairman, and members of the committee, my name is George E. Perrin. I'm manager of benefits planning and development for Eastman Kodak. Today I'm here representing the Association of Private Pension and Welfare Plans.

We appreciate the opportunity to appear before the committee and comment on S. 1992. Our specific interest is in that section of the bill which deals with the imputation of income to retirees under section 79.

We believe that group-term life insurance serves a socially useful purpose and oppose the proposal to require retirees to include in income the cost of such insurance in excess of $50,000 for the following reasons: First, it contradicts the long-standing concern of Congress and the American Society for Retired People.

Second, it is inconsistent with recently expressed concerns in Congress and the administration for the well being of surviving wives, as evidenced in S. 2769.

Statistics developed by the American Council of Life Insurance Co. in 1981 show that the majority of beneficiaries of all group-term policies are wives. Some 53 percent of all beneficiaries are spouses, wives of male employees.

In this regard, an example with which I am personally familiar: 86 percent of life insurance beneficiaries of retiring males at Kodak last year were wives.

Third, a person's income drops at retirement and becomes fixed, an inopportune time to increase taxes. That tax will have to come out of sources of income such as pensions and social security.

Four, group-term insurance is not just a benefit for tophat or key people. A broad range of retired people of all salary and wage levels are covered by group-term life insurance. Again, using my own company as an example, more than 6,500 retired Kodak employees have insurance of $50,000 or more. And in the years to come, as salaries increase, and since group-term life insurance in most instances is a function of salary, that number just has to grow.

It is understood that the proposal is not expected to have a significant, immediate impact on revenue, but is intended instead to curb abuses. If such is the purpose, we would clearly support an appropriate provision to curb abuses, such as the nondiscrimination rule that has been mentioned earlier, or perhaps a requirement that life insurance in retirement has to bear some relationship to the amount covered just prior to retirement.

Thank you very much.

[The prepared statement of Mr. Perrin follows:]

STATEMENT
OF THE
ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC.
BEFORE THE
SENATE FINANCE COMMITTEE
REGARDING
TAX TREATMENT OF LIFE INSURANCE PRODUCTS AND POLICYHOLDERS

Tuesday, January 31, 1984
Washington, D.C.

Mr. Chairman and Members of the Committee, my name is George E. Perrin, Manager, Benefits Planning and Development for Eastman Kodak. I am here today representing the Association of Private Pension and Welfare Plans, Inc. (APPWP). The APPWP is a non-profit organization founded in 1967 with the primary goal of protecting and fostering the growth of this country's private benefit system. The Association represents some 500 organizations located across the United States. Our member firms include hundreds of plan sponsors -- both large and small employers alike. Additionally, our membership includes leading organizations from every element of the employee benefits system: investment firms, banks, insurance companies, accounting firms, actuarial consulting firms, and various others associated with employee benefit plans. Collectively, APPWP's membership is involved directly with the vast majority of employee benefit plans maintained by the private sector.

We appreciate this opportunity to appear before the Committee to comment on S. 1992. We are here to discuss the section of the bill requiring retirees to include in income the cost of group-term life insurance in excess of $50,000 provided by a former employer.

Group-term life insurance has long been recognized as a cost-effective means of providing protection to surviving families. The cost of the first $50,000 of such insurance protection was made tax-free because it was considered desirable to encourage employee coverage by employer-sponsored group-term life insurance. A special exception permitted completely tax-free insurance for people who had retired because of age or disability in recognition of the special needs of retired people. Because of this encouragement, group-term insurance provided by employers has continued to expand, providing protection for many employees who would not otherwise be insured or would be inadequately insured. Thus, it takes a certain amount of pressure off of Social Security and other government-sponsored assistance programs.

Because we believe that group-term life insurance serves a socially useful purpose, we oppose the proposal to require retirees to include in income the cost of group life insurance in excess of $50,000. Such a requirement would contradict the longstanding concern of Congress and the American society for the welfare of retired persons. The total exclusion for retirees was based on the express recognition that "it would be undesirable to tax the aged...individual, who is no longer working, for group-term life insurance protection provided to him by his former employer." Senate Report No. 830, 88th Congress, 2nd Session (1964).

A more important reason for continuing the retiree exclusion is based upon the peculiar financial position of the retiree. Typically, one's income drops markedly upon retirement, which is therefore a most inopportune time to increase taxes. The group-term life insurance which will give rise to the added tax is not convertible to cash. Affected retirees will, therefore, suffer further reduction in their fixed incomes in order to pay the proposed new tax. Also, for the first time, Social Security benefits are now being taxed. As a result, retirees will have even less money available to pay additional taxes owed with respect to group life costs. If subjected to such a requirement, many of the retiree-beneficiaries who participate in our member plans will be forced to endure the hardship of including in income, and consequently, paying taxes on sharply increasing costs of insurance benefits not yet received at a time when their resources are diminished and fixed due to retirement. We feel that this hardship will result in a wholesale withdrawal by retirees from group life coverage and a decision by employers to eliminate such plans due to rising costs and administrative burdens. This would defeat Congress' initial goal of encouraging widespread life insurance coverage of employees and retired people.

One example of an employer who provides a substantial protection to retired employees and their dependents through group-term life insurance is the company I work for. On average, Kodak employees who have retired under a life insurance program, which was improved in 1979, have lifetime coverage amounting to $61,000 - $11,000 more than the $50,000 exclusion. Today, there are more than 6,500 retired Kodak employees with group-term life insurance of $50,000 or more. Since life insurance in many group plans like Kodak's is a direct function of salary, it can be expected that the number of retired people who will be adversely affected by the proposed legislation will increase as salaries rise in the years ahead.

For these reasons, we support deletion from the insurance industry bill of language which would tax individual retirees on the imputed-income value of employer-provided group-term insurance.

The portion of the bill relating to taxation of retirees is understood to have no significant or immediate impact on federal revenue and thus its apparent purpose must be to curb perceived abuses such as substantially increased life insurance coverage at retirement. If such is in fact the purpose, we would clearly support an appropriate provision designed to curb abuses, such as a requirement that the level of group-term insurance provided to retirees bear some reasonable relationship to the level of insurance coverage provided before retirement.

The system of benefits protecting retired people in the U.S. is unique. In addition to government-provided benefits such as Social Security, Medicare and Medicaid, the private sector provides pensions, post-retirement death benefits, and health care benefits for retirees and their survivors. It is important to maintain a stable climate in which this system can develop and grow. We believe consideration of legislation, such as the proposed amendment to Section 79, should be separate and apart from this legislation, which deals with the taxation of life insurance companies.

Even without regard for the retiree issue, the level of employer-provided group life insurance which may be excluded from the income of employees should be adjusted from $50,000 to $150,000.

The $50,000 level was imposed in 1964. At that time, $50,000 provided a moderate amount of insurance for a middle-income family. However, consumer prices have increased by over 225 percent since 1964. In view of the effects of inflation, $50,000 of life insurance does not provide adequate protection to many families today.

An increase in the exclusion level would further strengthen the incentives for employers to set up non-discriminatory programs of group life insurance and to provide greater amounts of insurance to employees. The retention of the current $50,000 level may merely encourage employers to continue lower amounts of insurance coverage for rank-and-file employees while providing additional insurance outside of the group life provision for the higher paid employees.

American Council on Life Insurance statistics, compiled in 1981, indicate that 52.9% of group life beneficiaries are wives. This group of beneficiaries is five times greater than any other specific group of beneficiaries. Our experience at Kodak is similar. The majority of employees -- more than 80% -- elect their spouse as primary beneficiaries. The Senate has recently enacted H.R. 2769 which, among other things, is intended to protect surviving non-working spouses, particularly wives, under retirement plans in the case of the premature death of an employee, by requiring a survivor annuity. The Treasury Department and many private groups have indicated that the non-working surviving spouse would be better protected through group life arrangements. Group life arrangements may provide greater amounts of money than under a retirement plan and provide a substantial tax benefit in that they are fully excluded from income. In addition, some groups have indicated that the expanded death benefit requirements for pension plans may result in reductions in employer-provided group life insurance coverage. An increase in the group life exclusion would be responsive to these concerns by providing a substantial incentive for employers to expand non-discriminatory group life programs -- to the potential benefit of all employees and their families and especially women, the preponderant group of beneficiaries of group life.

We have additional recommendations concerning technical and administrative problems with the group life grandfathering position and with respect to the problem of abuses. We would like to work with your staff on these recommendations.

Thank you for the opportunity to testify.

STATEMENT OF GLEN A. HOLDEN, PRESIDENT, SECURITY FIRST LIFE INSURANCE CO., LOS ANGELES, CALIF.

Senator **Chafee**. Mr. Holden.

Mr. **Holden**. Mr. Chairman, members of the committee, I'm Glen Holden, CEO, Chairman of Security First Life Insurance Co. And while I am very much affected by the tax bill, I'm in accord generally with it as it is. However, I'm here today to speak with regard to the taxpayer, the policyholder provisions, with particular respect to the annuity provisions covered under section 222.

We feel that 222 should be stricken from the bill; that it actually hinders and is onerous to the continued self-reliant American who provides for himself. And at the same time, we are prepared to give you and your staff demonstrative evidence that it will not raise more tax revenue if it is kept in, but rather just the opposite. We are prepared to give that evidence to you.

We feel further that these annuity contracts are being purchased by people who are income earners in moderate income ranges; not high income ranges. And believe me our America today needs more investment in annuity contracts by the self-reliant American.

Also you should consider that not only can we demonstrate that this could be more beneficial from a tax revenue standpoint if you take 222 out of the tax bill, but further we also submit that the investment in annuity contracts, which are long-range investments, allow the insurance institutions to invest in mortgages and long-range investments that help build America.

Thank you very much for your time.

Senator **Chafee**. You state that you can demonstrate that there would be greater tax revenue for the Government, how? Do you have some material that you can submit to us?

Mr. **Holden**. I do. Just briefly, it has to do with the following—with respect to most of these annuities that are sold, the money that is received by the insurance company goes immediately into the account of the taxpayer policyholder and the insurance company dips into its surplus account to pay for the commissions and the distribution costs which in that year produced taxable revenue to the distributors and salesmen of the annuity contracts. Further, while there is a deferral of interest in the second years and thereafter for the policyholder, there is a profit being made and therefore a taxable revenue to the insurance company. And, yes, we will be happy to provide you and your staff with figures that I think will be highly convincing to you.

Senator **Chafee**. Fine. Thank you very much.

[The prepared statement of Mr. Holden and the figures follow:]

STATEMENT OF

GLEN A. HOLDEN
President and Chairman of the Board
Security First Life Insurance Company

Hearing Before the Senate Committee on Finance

Tax Treatment of Life Insurance Products and Policyholders

January 31, 1984

Objections to the Passage of Section 222 of S. 1992 and Correction of the Tax Treatment of Certain Capital Gains

Section 222 of S. 1992

In recent years, Congress has demonstrated its recognition of the need for Americans to provide for their retirement years by passing laws to provide increasing tax incentives for various plans to accumulate retirement income. These plans (the so-called HR-10 Plans and IRA Plans) permit the use of pre-tax dollars in accumulating retirement savings; thus, in a sense rewarding people who took steps to provide for their retirement years. We in the insurance industry have welcomed the Congressional actions in creating and expanding the so-called HR-10 and IRA plans even though the structure and availability of such plans represented competition with traditional insurance products. The laws creating these broadly available tax incentive plans were truly in the interest of making Americans self-reliant in their retirement years and, therefore, in the best interest of the entire country.

For many decades, an insurance product has existed that gives a person the ability to build a retirement nest egg that he or she can not outlive, albeit without any significant tax incentives but with tax protection on accumulations to the nest egg. That product is the annuity contract.

In the last few years while HR-10 and IRA retirement plans have been the subject of increasingly attractive revisions in the tax laws, we have witnessed a steady attack on the use of life insurance products as a medium for providing retirement income that is without precedent and, I might add, without justification.

It is understandable that when tax revenues need to be increased, the burden must be borne fairly by all taxpayers in the same posture. Thus while I do not believe that the increase of tax burdens on insurance companies is something that our business can welcome, I do not disagree with the life insurance company tax provisions of S. 1992. I do disagree strongly, however, with the provisions of Section 222 of S. 1992 as being an unwarranted and unjustified attack leveled at policyholders. An attack that runs contrary to the concept of encouraging people to provide their own retirement income.

Whether or not policyholders are subject to tax will not affect the tax burdens of insurance companies in any way nor, I submit, will the provisions of Section 222 add to the general tax revenues of this country to any discernible extent. The only purpose to be achieved by Section 222 is to discourage the use of annuities as a retirement planning tool.

Less than two years ago, Congress passed the Tax Equity and Fiscal Responsibility Act ("TEFRA"). This Act represented a serious impediment to the use of an annuity as a retirement tool. At the time Section 72 of the Internal Revenue Code was amended by TEFRA we were told it was to correct perceived abuses. TEFRA changed the method of taxing amounts withdrawn from an annuity and imposed a penalty tax. It was understood by the insurance industry that these annuity tax revisions would be "permanent" and that no additional changes needed to be made. This understanding was substantiated by Assistant Secretary of the Treasury Chapoton in 1983 when, in discussing the tax deferral nature of annuity contracts, he stated that the Treasury staff "think[s] that this [TEFRA] is a satisfactory solution and we have no plans to seek any further changes in the tax treatment of annuities."

Section 222 contradicts the clear words of the Assistant Secretary. The provision imposes further drastic restrictions and limitations on annuities by (a) eliminating the 10-year holding period exception provided in TEFRA and (b) subjecting any accumulations in the annuity of a person who dies before annuitization to both an income tax as though it had been received by the owner before death and an estate tax on the deceased owner's estate.

(a). Paragraph (a) - Elimination of the 10-year rule. The requirement that a person hold the annuity ten years to avoid the penalty tax on withdrawal was designed to correct the perceived abuse that some annuities were being used as "short-term investment vehicles." The proposed change of the TEFRA provision in Section 222 creates an unreasonable and excessive extension of the penalty tax. Surely it cannot be charged that a person uses an annuity as a short-term investment vehicle if he is precluded from withdrawals for ten years on the threat of a penalty tax! It is difficult for an annuity buyer to get interest guarantees for that period of time, and even if he could, a 10-year interest guarantee certainly could not be considered a "short-term" investment. Further, such a change would discourage younger buyers of annuities who want and need to make provision for their future financial security and retirement. An individual buying an annuity at age 35 is exposed to a penalty tax for 24 1/2 years (until age 59 1/2) if, because of some unforeseen emergency, he should need to withdraw. While responsible individuals plan for their future, they know that their circumstances may change and that they may need their money for other legitimate purposes. Such an unreasonable extension of the penalty tax provision will discourage people from purchasing annuities to provide for their retirement.

There should not be any additional burdens placed on an annuity which, unlike an HR-10 or IRA Plan, can only be purchased with after-tax dollars. An annuity by itself cannot be as advantageous to the purchaser as a tax qualified plan. Therefore, the annuity and the annuity purchaser should not be subjected to the imposition of additional burdens that will impair their use even further. The only discernible result of Section 222 would be to discourage the purchase of annuities with after-tax dollars.

(b). Paragraph (b) - Taxation on death before annuitization. This provision is without any legitimate application. There is no abuse to be cured in this area and it cannot be said to generate any significant tax revenues. It is simply a deterrent to the sale of annuity contracts. People buy annuities at all ages to plan for their retirement. When they buy annuities, most do not know when they wish or need to commence receiving their income payments nor when they will die. Even if they thought they knew, their circumstances may change; they may need to advance the date to age 60 or extend it to age 75. Today, more people are working actively to age 70 and beyond. The great value of an annuity as a retirement vehicle is the flexibility it provides in letting the person accumulate retirement income on a tax-deferred basis until the time he actually needs to start receiving his income, and at that moment, decide what type of annuity pay-out he needs to receive, i.e., over a 10-year or 15-year or 20-year period or over his lifetime.

The proposed change creates for the legitimate annuity buyer a continual sword of risk hanging over his head that at any moment he may die unexpectedly before he had reached the time when he wished and needed to annuitize, and that as a consequence of his untimely death an immediate income tax on the earnings of his annuity is incurred as if they had been paid to the decedent before death and an estate tax is imposed on the proceeds in his estate. Thus, this double tax burden would be imposed on the one person who never received a penny of the annuity income while living.

The proposed change raises other questions that can only add confusion to what is now a clear statement of law:

1. It refers to the death of the "holder" of an annuity. Who is the holder of an annuity? Is it the owner of the annuity? Many annuities make provisions for a "contingent owner" to whom the ownership passes upon the death of the original owner. What about joint owners or joint and survivor owners, or joint annuitants with equal rights?

2. What if the annuity buyer included a "spendthrift" provision restricting the pay-out to the beneficiary on a certain basis, i.e., life annuity - should the beneficiary be forced to pay income taxes as though he or she received payment of the entire lump sum when in actuality the beneficiary can only get the money over a period of many years or during his or her lifetime? Should the estate of the decedent be required to pay income taxes on distributions that must go to a beneficiary?

3. The proposed change would unnecessarily render Section 72(h) ineffective and inoperative. Under Section 72(h) of the IRC, a beneficiary who has not had an election made for him or her has 60 days in which to elect an annuity pay-out or to receive a lump sum distribution and pay the entire income tax at that point. The proposed change does not add a tax, it merely imposes the tax upon the improper party at the death of the holder to the detriment of the beneficiary who, in all

likelihood, needs the tax planning ability the most. Section 72(h) is a good provision that has been in our tax law for many, many years and no one has ever suggested that it be changed.

There are no logical reasons to support the proposed changes of either paragraph (a) or paragraph (b) of Section 222.

1. They have no significant revenue impact.
2. There is no reason to make non-qualified annuities similar to IRA's. An IRA is purchased with pre-tax dollars and, up to $100,000, is excluded from estate taxes. Non-qualified annuities are purchased with after-tax dollars and do not enjoy estate tax exclusion.
3. These changes will sharply lower annuity sales and will have substantial adverse impact upon a number of smaller life insurance companies whose annuity sales make up a substantial portion of their business.
4. These changes are unwise on the basis of public policy considerations. At a time when we need to encourage savings and motivate people to provide for their own future security and retirement, it appears contrary to the public interest to impose further restrictions on annuities which will certainly eliminate their attractiveness as a retirement vehicle.
5. The industry and the Government had an understanding that the revisions in 1982 were final. The proposed changes violate that understanding.

For all of the above reasons, I respectfully urge the Senate to reject any changes in the taxation of annuities at this time as being contrary to the avowed public policy of encouraging Americans to independently provide for their own retirement security and income.

Request for Correction of Certain Capital Gains Tax Treatment

There is a point where I believe that the tax laws relating to the general area of taxation need to be addressed and corrected. That point concerns the tax treatment of realized capital gains in variable contract separate accounts. Capital gains realized in insurance company separate accounts have been improperly treated for quite some time. The assets in an insurance company separate account are held exclusively for the benefit of policyholders. If there are gains in the separate account they increase the value of the policyholder's contract.

The basic premise of life insurance taxation is that any portion of an insurer's investment income used to increase policyholder's values in an insurance policy or annuity contract is treated as a increase in reserves and, therefore, deductible to the insurer. The premise is what we will refer to as the "inside build-up" on policies. It has long been recognized that this inside build-up is the only way an insurance policy can truly work and it is the only way in which double taxation is avoided.

There is one serious flaw in the treatment of inside build-up. While there has never been a question as to the need to provide the deduction for insurers when policy values increase, through apparent inadvertence, this treatment is not available to capital gains investment income credited to the values of variable contracts funded in insurance company separate accounts. Under present law, the insurer is obligated to pay a tax on any long-term capital gains realized in a separate account, thereby reducing the assets in the separate account by the amount of such tax. The policyholder is not given credit in any way for the payment of such tax. The result of this apparent flaw is a form of double taxation on variable contract holders. The insurance company must pay a tax on any such realized gains and, when the proceeds of the contract are distributed, the policyholder will again be taxed on the net amount of the gain at ordinary income tax rates.

I suggest that this apparently inadvertent flaw be corrected by amending the Internal Revenue Code to eliminate the taxation of capital gains realized in an insurance company separate account.

2/2/84

DEMONSTRATION OF TAXES LOST BY PASSAGE OF SECTION 222

	INDIVID ANNUITY PREMIUMS (MILLIONS)	ONE HALF LOST (MILLIONS)	ANNUITY RESERVES (MILLIONS)	MALE AGE 50 DEATH RATE	TAXES COLLECTED SECTION 222 (MILLIONS)	TAXES LOST (MILLIONS)	EXCESS OF LOST OVER COLLECTED (MILLIONS)
	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1980	6,396		31,543				
1981	10,091		38,800				
1982	14,936		51,002				
1983	19,000		63,000				
1984	24,000	12,000	78,000	0.00406	29	180	151
1985	30,000	15,000	97,000	0.00406	35	225	190
1986	35,000	17,500	119,000	0.00406	43	263	219
1987	40,000	20,000	143,000	0.00406	52	300	248
1988	45,000	22,500	169,000	0.00406	62	338	276
1989	50,000	25,000	197,000	0.00406	72	375	303
1990	55,000	27,500	227,000	0.00406	83	413	330
1991	60,000	30,000	258,000	0.00406	94	450	356
1992	65,000	32,500	291,000	0.00406	106	488	381
1993	70,000	35,000	325,000	0.00406	119	525	406
TOTAL	524,423	237,000			696	3,555	2,859

COL.2:ACTUAL INDIVIDUAL ANNUITY PREMIUM SALES FROM 1980-82. THEREAFTER PROJECTED
COL.3:THE PORTION ASSUMED NOT TO BE SOLD IF SECTION 222 PASSES.
COL.4:ACTUAL INDIVIDUAL ANNUITY RESERVES HELD BY INSURERS FROM 1980-82. THEREAFTER PROJECTED.
COL.5:ASSUMED MORTALITY RATE APPLICABLE TO ALL IN FORCE ANNUITIES
COL.6:ASSUMED TO BE RESEVES TIMES MORTALITY RATE TIMES 30%(PORTION REPRESENTING
TAXABLE INTEREST) TIMES 30% ASSUMED TAX RATE
COL.7:ASSUMED AMOUNT LOST FROM TAXES (AT 30%) ON COMMISSIONS (AT 5%) ON LOST PREMIUMS

STATEMENT OF STUART E. EIZENSTAT, POWELL, GOLDSTEIN, FRAZER AND MURPHY, WASHINGTON, D.C., ON BEHALF OF KARR/BARTH ASSOCIATES AND MID-AMERICA ASSOCIATES, PHILADELPHIA, PA.

Senator CHAFEE. We welcome an old friend whose has been active, of course, on the Hill, Mr. Eizenstat.

Mr. EIZENSTAT. Thank you, Mr. Chairman.

I appreciate the opportunity to testify against the policyholder loan provisions in section 223 of the bill on behalf of two independent life insurance brokerages. Accompanying me today is George Karr of Karr/Barth Associates.

My clients deal in traditional life insurance products for the middle and upper middle income market. It is these basic policies which are threatened by the across the board policyholder loan interest deduction limitations. This exercise began as an effort by the IRS and Treasury to stop the proliferation of high cash value, tax shelter type investments carefully crafted to qualify as life insurance, which gave a few investors the opportunity for substantial arbitrage and tax advantages when the investor borrowed from the policy.

The testimony of Treasury makes clear that this was the target of tax reform. We fully share this goal. My clients do not sell such investments and the policies, indeed, such as these, provide unequal competition with the traditional type whole life policies, which both the Congress and the Treasury told the insurance industry would be left undisturbed. However, the bills pending before both this committee and the House do not target these abusive policies alone, but rather choose a remedy which attacks traditional whole life policies and abusive policies alike and indiscriminately. The good is treated no differently from the bad by the blanket limitation on interest deductions from borrowings on all policies. This is the wrong approach to a limited problem. It is a limited problem which requires a limited and targeted response. And the remedy which is chosen directly threatens, therefore, traditional whole life policies, which are the bedrock American institution encouraging savings, which are now near an all time low, and providing an incentive, of course, for family protection.

Small businesses use whole life policies for key man or woman insurance or as part of buy-outs. There is no abuse here since companies can borrow the money from banks for the policy and deduct the interest. With financial deregulation, there is already a disincentive to the purchase of whole life policies. The ability to borrow and deduct interest charges is a critically important feature to encourage continued use of whole life policies. Any across the board ceiling creates a chilling effect on the market, restricts the use by small businesses of key person policies, and provides a ceiling which Treasury will inevitably attempt to lower—indeed, their first suggestion was for a much lower ceiling

Abusive polices can and should be discouraged. They are easily distinguishable from the traditional life products by the exceedingly large cash values in the early years, by the fact that cash values are a substantial percentage of death benefits throughout the policy term, and by the fact that they offer little or no death benefit.

The proper remedy, Mr. Chairman, therefore, to such abusive investments is not to restrict borrowing on all policies, but rather to adopt a strict corridor-type definition relating cash values to death benefits at various ages and then to eliminate entirely or at least restrict severely interest deductions on those types of abusive policies, policies which do not measure up to the definition.

A definitional approach has already been approved by the Treasury and the Congress in the 1982 provisions on universal life insurance, and on the treatment of death benefits, and is included in section 221 of the bill. If time does not this year permit further refinement of a corridor-type definition strictly for interest deduction purposes, to target the abusive policies, then the deductible limitation in section 223 should be eliminated entirely this year and Congress next year should work on crafting such a corridor-type provision.

The provision here has no relation to the stop-gap provisions and is not a significant revenue raiser. Section 223 should therefore either be modified so that it targets only abusive policies or it should be dropped if time does not permit.

Senator **Chafee**. Thank you.

[The prepared statement of Mr. Eizenstat follows:]

STATEMENT OF STUART E. EIZENSTAT
BEFORE THE COMMITTEE ON FINANCE
JANUARY 31, 1984

Mr. Chairman and members of the Finance Committee, my name is Stuart E. Eizenstat, and I am a member of the law firm of Powell, Goldstein, Frazer and Murphy in Washington, D. C. Accompanying me is George Karr of Karr-Barth Associates.

I am testifying on behalf of Karr-Barth Associates and Mid-America Associates, which are independent life insurance brokerages servicing the middle income market. My clients deal in traditional life insurance products, and they share the concern of this Committee over the proliferation of high cash value, tax-shelter type investments designed to qualify as life insurance. The stated intent behind the limitation on policyholder loan interest deductions in the pending life insurance legislation is to combat such abuses without affecting the use or marketability of traditional whole life insurance. Unfortunately, any across-the-board policyholder loan interest deduction limitation, regardless of dollar amount, equally affects traditional, "vanilla" whole life policies and investment-driven, abusive policies. Further, even at the $500,000 level adopted by the House Ways and Means Committee and included in S. 1992, the interest deduction limitation will discourage the legitimate use of life insurance by small businesses in situations where there is no abuse of the income tax system whatsoever.

Abusive life insurance products are generally identifiable because the investor can borrow and reinvest a substantial portion of his premium payments. The reinvested premiums accumulate within the policy free of tax while the investor receives a deduction for the interest charged on the policy loan. For abusive products, this arbitrage results in a high internal rate of return competitive with other market rate investments without taking into consideration any insurance protection (i.e., excess of death benefit over cash value).

The purchase of traditional, whole life insurance, on the other hand, is a long-term financial commitment. The option to borrow from the policy often provides the security necessary to induce a prospective policyholder to undertake that commitment. This is particularly true in the case of many small businesses where whole life insurance can serve the important function of guarding against contingencies which could otherwise wipe out a new enterprise. For example, many small businesses purchase key-man life insurance as compensation in the event of the premature death of vital personnel. Alternatively, the owners of a small business may use life insurance to fund a corporate buy-out plan which will enable the business to survive the death of an owner. In both these cases, substantial amounts of insurance protection may be necessary; however, it is the *death* protection element of the insurance policy (the pure insurance element) which is essential. In these situations, a $500,000 interest deduction limitation is a disincentive for the purchase of insurance which is important for the survival of the small business.

Nor does a flat $500,000 cap make good sense in the case of established corporations which take out large policies on their key officers since there is no indication that abuses are occurring here. Indeed, a large, established enterprise with sufficient credit available from other financial institutions can borrow an unlimited amount of funds from a commercial bank to pay its life insurance premiums even if its ability to borrow from the policy is limited by new legislation. Since the interest on any amount of such borrowing from a bank is deductible, the only disadvantage to the established corporation from a limitation on the deductibility of policyholder loan interest would be the potentially higher interest rate charged by another financial institution. Moreover, the Treasury will be no better off since the higher interest rate charged by the commercial bank will lead to higher income tax deductions for the corporate insured while the tax treatment of the insurance product, itself, will be unaffected. (It should be noted that the premiums for such non-group life insurance policies are not deductible, and, therefore, there is no revenue drain on the Treasury due to the purchase of these products.)

A small business, on the other hand, may be reluctant to use available outside credit to purchase life insurance protection because of the long-term nature of this commitment and uncertainties over the future capital needs of the business. Accordingly, those businesses which are most at risk will be the most easily deterred from purchasing insurance protection under the proposed legislation. Further, to the extent that corporations use limited outside credit for insurance purchases, funds which would otherwise be available for business expansion may be exhausted. For all these reasons, the dollar limitation adopted by the Ways and Means Committee is ill-advised and will harm exactly those small businesses we should be encouraging.

Accordingly, I would like to propose that this Committee target abusive life insurance products in a manner which fully protects legitimate whole life insurance policies. This can be accomplished by restricting any allowable interest deduction for policyholder loans to loans from those policies which provide a substantial amount of death protection above the cash value, i.e., traditional whole life insurance products. For this purpose, a corridor-type definition of an eligible life insurance product could be developed which would insure that the products which are desirable investments wholly apart from the inclusion of any insured death benefit, would not qualify for loan interest deductions.

The most accurate definition which would exclude purely investment-oriented products while permitting the unrestricted purchase of traditional whole life insurance by persons of any age or by corporations or other businesses would be in the form of an age-specific corridor limiting the ratio of cash surrender value to death benefit according to the age of the insured at the time the policy was purchased and the length of time during which it has been in force. Interest deductions for all borrowings from a policy which met these criteria would be permitted; whereas, no deductions whatsoever would be allowed for interest payments on loans from non-qualifying policies. (Alternatively, a limit on loan interest deductions could be applied only to non-qualifying policies.) The insurance company would be required to notify each purchaser in writing as to whether his policy would be eligible for interest-deductible borrowing, and penalties could be imposed on companies supplying false information. Thus, this solution would completely protect the traditional life insurance product while excluding investment-oriented abusive policies from the tax benefits accorded to life insurance.

My clients would be pleased to supply the services of an actuary to work with the Committee staff at its convenience in order to develop the appropriate definition of an eligible life insurance product. In addition, my clients would make available to the Committee any data concerning insurance products and industry practices of which they are aware. In this manner, we believe that an appropriate definitional solution could be developed promptly and in time for legislative action this year.

However, if the demands on your Committee preclude such an inquiry at this time, we believe that legislative action affecting life insurance products should be deferred. Omitting any policyholder loan provision from this legislation would be preferable to the approach, first adopted in the House bill, which does not distinguish between traditional life insurance policies and abusive ones. There is no necessity to act on the policyholder loan issue at this time. Life insurance products are not subject to any expiring provisions of the tax law which require immediate action. Moreover, a policyholder loan deduction limitation raises no significant revenue. The tax treatment of life insurance products affects millions of policyholders with potentially severe ramifications which have never been thoughtfully considered due to the suddenness of the introduction of the loan interest limitation in the House bill this summer. Until that time, my clients believed that traditional, whole life insurance products would not be affected in any way by legislation contemplated by this Congress.

Traditional whole life insurance provides more than 95 percent of the death benefits actually recovered by policyholders. Thus, it is the primary means of protecting families and small businesses from the catastrophic consequences of the death of a provider or employer. It is a prove. and important method by which Americans can save, protect their families, and yet borrow for a rainy day, for special needs, or for the education of their children. Any cap on interest-deductible borrowing would have a chilling effect on whole life insurance, which is a bedrock American industry.

By contrast, term insurance premiums rise geometrically as an insured nears the end of his normal life expectancy (coinciding with the usual drop in income due to retirement). Thus, most insureds drop their term insurance coverage during their lifetimes and receive no benefits whatsoever. If a policyholder loan interest deduction limitation is enacted clouding future investments in whole life insurance, many more policyholders will rely on term insurance and sacrifice lasting financial security for their families.

Accordingly, I urge you to strike the policyholder loan interest deduction limitation and to develop instead a definitional approach which will target abusive policies while protecting the traditional whole life insurance which is an essential component of our country's savings and security. Even if such a definition cannot be enacted this year, the policyholder loan interest deduction limitation, adopted from the House bill, should, nevertheless, be deleted from S.1992.

I am very grateful for the opportunity to testify before this Committee. Mr. Karr and I would be happy to answer any questions you may have.

Senator CHAFEE. The other gentleman, are you here to testify?

Mr. SMITH. He has completed our testimony. We will be happy to answer questions, sir.

Senator CHAFEE. I don't quite understand the rationale that Mr. Regan and Mr. Perrin expressed that it's perfectly all right to pay an income tax on premiums for group term life insurance over $50,000 that you receive while you are an active employee, but there is something immoral about paying tax on these premium after you have retired. What is the difference?

Mr. REGAN. When an employee has retired, as stated previously, that's when income is reduced, and that's certainly the time when tax benefits should be considered and certainly not additional taxes imposed.

Senator CHAFEE. These are not additional taxes, so don't say that. You pay the taxes on the premiums for the insurance in excess of the $50,000 while you are working with the company. Is not that correct?

Mr. REGAN. That's correct.

Senator CHAFEE. So you are not subject to additional taxes. Under this proposal you get the $50,000 coverage tax free, but you pay taxes on amounts of insurance coverage above that. If your insurance is $100,000, you are paying a tax on the premiums for the extra $50,000. When you retire, you would still pay a tax on this extra coverage. Now maybe due to the terms of the group life, it's more costly, but it has been more costly as you moved up through anyway, hasn't it, in the company?

Mr. REGAN. As your ages increase during your working years, your income has also increased. Now once you retire, obviously, your income is still not increasing, and, in fact, not staying level. So that is when I think we should be—it would seem like sound social policy to encourage the provision of group life insurance coverage to retired employees, and to do that in a manner in which we take into consideration the extra economic burdens faced by retired employees. There are two exceptions—both retirement and disability—that Congress saw fit when they considered the changes to section 79 in 1964 to enact. Both are really hardship sections, if you will. That's someone who is disabled or if they are retired, and they are certainly not at their peak income years.

Senator CHAFEE. Well, I know that any provision that distributes more money to beneficiaries, survivors, widows, tax free is splendid. But as I mentioned in my opening remarks, we are confronted with a $200 billion deficit in running the country so we just have to seek to get revenue where we can. That's what is driving us. Certainly, it would be wonderful if there were no taxes on anybody over 65. That would really be helping the elderly. But we are not in a position to do that.

Senator PACKWOOD. Dr. Chasey, your organization was not consulted at all in this compromise, were they? It's not a question of do you want to join, and you don't join. You weren't even consulted.

Dr. CHASEY. No; two major groups were consulted in this. We were not part of any compromise at all.

Senator PACKWOOD. That's what I thought. The argument is being held out that all of the major players in the insurance industry—agents, business—were all part of this compromise and anybody that was left out is just kind of a rag-tag hair-shirt organization that has no real interest. [Laughter.]

Dr. CHASEY. Yes; that's exactly what is happening. I might say that the testimony that we have presented both orally and in written form would reflect the major interest of the agents, if they had not agreed to a compromise.

First of all, there was a very low limitation on the interest deduction—$50,000. When you have got $250,000, you say, where are we going to go with it? And we noticed some fear today that we won't get any legislation unless we agree to the whole package. But in that process a lot of people were left out; yes, sir.

Senator PACKWOOD. When I was last in Oregon, I talked with a number of agents. And I don't mean the ones that would just necessarily be writing these kind of policies. I'm just talking about the average agent. They don't write very many policies like this. And I can understand why they want to deal—and their companies have called them about a bill. And it is not that they are in any way for or against the policyholder provisions. For most of them, they were irrelevant. And to say that they are wedded in bond to those provisions simply overstates their position. They don't care one way or the other.

Dr. CHASEY. I think it's also interesting that neither of those groups are testifying today in that the compromise was cut and they are staying by that compromise by not testifying rather than in support of.

Senator PACKWOOD. No other questions.

Senator CHAFEE. Senator Bentsen.

Senator BENTSEN. Thank you very much.

I certainly share the chairman's concern and Senator Chafee's concern with the deficit we are facing, but I would like to ask Dr. Chasey to comment on what he thinks the revenue impact would be if the cap was taken off on the $50,000.

Dr. CHASEY. On the $50,000? John would probably be the better one to respond.

Senator BENTSEN. Give it to me on the borrowing then. Give them both, if you have it. That would be helpful.

Dr. CHASEY. Let me just say on the borrowing that the feeling that we have from policyholders is that if there is the limitation—and we have an example in our written testimony using different figures than Mr. Chapoton did—that at age 64 then there would be no borrowing ability left. Therefore, at age 45 the individual wouldn't buy the policy knowing that at age 64 he would not have the opportunity to borrow against that policy. So, therefore, people will not buy the policies; will go into some other type of revenue program. And, therefore, the Treasury will not receive any money.

Senator BENTSEN. So you don't see a revenue impact on that limitation?

Dr. CHASEY. I see a negative on that aspect. That the policies, even though there may not be that many, will not exist. They will go away. And, therefore, the Treasury will not benefit in any way on that.

Mr. REGAN. On section 79 changes, again, it's difficult to assess what the revenue impacts of the $50,000 limitation would be. I think there are two concerns there. No. 1, it could cause widespread cancellation of postretirement death benefits, and anything that would discourage postretirement death benefits to any segment of the employee population would seem to be unwise policy. Second, for that retired employee who now gets a 1099 on a benefit from their previous employer, I would suggest in most cases that they are probably not going to understand it; probably not going to report it. And, therefore, it's unadministrable insofar as any tax revenues.

Senator BENTSEN. I'm not sure I agree with that last comment. But I appreciate your other comments.

The CHAIRMAN. And following on Senator Chafee's question, the retired employee has to pay tax on his pension which he uses for food and clothing, right?

Mr. REGAN. That's correct.

The CHAIRMAN. So why should his term life insurance be completely excluded?

Mr. REGAN. What we are talking about is the fact that it is excluded now, Senator. And why should we be changing that to taxable——

The CHAIRMAN. I didn't ask you that question I asked you why should it be excluded. We are going to have to change a lot of things around here if we are going to get ahold of some of the problems in Government.

Mr. REGAN. As stated previously, whether it's retirement or disability, this is a time when an individual income goes down.

The CHAIRMAN. So does his tax rate go down when he is retired. Right?

Mr. REGAN. That's correct. The tax rate goes down. The ability to pay goes down. Group life insurance is different from the pension—if it creates additional taxable income after retirement—it does not create with that the additional cash to pay the tax. So from that standpoint it's a little bit different than retirement income.

Mr. PERRIN. May I comment on that, Senator?

The CHAIRMAN. Sure.

Mr. PERRIN. I think the long-range implications are that there will be a curtailment and cutback of employer provided group term life insurance for retirees. As the retirees themselves drop coverage or have to drop coverage, employers are going to see this dissatisfaction, and they themselves will drop plans. Now this may not happen this week or next week or next year, but certainly as salary increases occur and more and more people are impacted by this, in my opinion, that is definitely going to happen.

The CHAIRMAN. What percentage of your annuity customers actually take their accumulated savings in the form of an annuity rather than just taking the accumulation, a lump sum like you could from any savings account? Do you have any of the percentage figures?

Mr. HOLDEN. Senator, I don't have the exact percentage. However, I can offer you some very enlightening information. Several years ago our company decided that we should sell only annuity contracts instead of something that might be cashed in later on. So we commenced selling a policy whereby 50 percent or more of all of the money that they put in would have to be taken as an annuity income, and could not be surrendered. Many people told us we were crazy. And both our distributors and some of the public to begin with.

You will be interested to know that from that day forward our sales have increased, and we are still selling that product. And on those products, all of the policyholder proceeds, more than 50 percent of all of the policyholder proceeds, are distributed in the form of actual annuity. So I think that everybody would probably like that kind of thing.

The CHAIRMAN. This may have been said in some of the statements. I understand that some people use annuity contracts to provide for savings for their children's education and other socially useful purposes. But under current law they can also use it to buy a yacht or anything else. Would it better to limit the use of annuities to retirement purposes by having rules like IRA's? And then if we wanted to encourage other savings programs, do it through some other legislation?

Mr. HOLDEN. Well, of course, I'm in favor of IRA as it is, and even as the President is recommending, very much in favor of that. But we are covering a whole different segment of the population. And our annuity contractors are used for many different purposes. And I think that that would not be advisable for this reason.

As you know, they must be currently held for 10 years or longer in order to not have the penalty tax. And, therefore, it's obvious that we ought to try to encourage people in their twenties and thirties to start to save in the long range investment program for their children's education and for other things. I really don't see much of the proceeds of annuity contracts buying yachts and so forth but I suppose any property could be purchased.

The **Chairman**. Just as an example.

Mr. **Holden**. I would like to make the point that I believe we should not make a restriction on the purpose. The important point is that the average American, self-reliant American, start to save money. And we can give you plenty of evidence that they are willing to do that. And in this time where social security and other pension benefits are in question—and remember I ended my discussion with the point that we are prepared to give evidence to you and your staff that by eliminating section 222 you will probably increase the tax revenue to the Government instead of decreasing it. And we are prepared to give you those figures.

The **Chairman**. Thank you.

Senator **Chafee** Well, in case there is any doubt, where I come from, taking your money out to buy a yacht is considered socially desirable. [Laughter.]

Thank you.

Senator Boren.

Senator **Boren**. Mr. Chairman, just very briefly in the interest of time, Mr. Eizenstat mentioned the chilling affect that the consideration of these changes has already had on the market. And I think we all recognize that there are benefits to society and particularly to small businesses and others to have whole life coverage under certain circumstances.

Describe why this has already had such a chilling affect? What kind of magnitude of change would you anticipate in the market if it is carried through? And is it really the fear that once a cap is placed on that that cap might be whittled downward, that it might be whittled away? Is that having the most negative impact as opposed to the actual dollar figure on the cap now?

Mr. **Eizenstat**. I think it's twofold. First, the dollar figure will have some direct disincentive. But the chilling effect is also psychological and becomes very real because once a cap is established the incentive is to lower the cap. And, indeed, the House has already shown an interest in doing that. The original provision was for $50,000. It was changed only at the last minute. And that gives an idea of the direction in which this will go.

If, Senator, there is a desire to attack abusive, high cash value, front loaded policies, that is something that can be done by a strictly targeted corridor provision. And we would support it. But an across the board cap is a signal to all potential policyholders that life insurance is not going to be the kind of investment in the future that it has been in the past. And at a time of financial deregulation when there are already substantial incentives not to invest in life insurance, despite the death benefit protection, this is yet another disincentive.

Senator **Chafee**. Could you give us, without going into too great detail, what you would do to curb abuses in lieu of the general cap?

Mr. **Eizenstat**. Well, for example, one can fairly easily distinguish these abusive policies from traditional policies by the amount of cash value relative to death benefits. If you had a policy, which, for example, in its first year had anything in the 10-, 12-percent range in terms of cash value, you are dealing with something that may not be a traditional policy. We would suggest a really quite strict corridor definition, something in which you had around a 3- to 5-percent cash value in the first year so that you could distinguish the traditional policy, which is not bought for investment purposes, but is bought for protection purposes, yet on which borrowing is an important incentive, from those in which the major incentive is to get the cash value up front and then borrow off of it.

So that's the type of provision we are talking about. It is something that I think the committee staff would be fairly familiar with. And we would be more than happy to work with the committee to attempt that type of distinction.

Senator CHAFEE. Did you hear Secretary Chapoton refer to page 23 of the joint committee print? Take a look at page 23. Now maybe this is catching you short because you haven't had a chance to look at it, but page 23 contains a description of a case in which there is no guaranteed cash value at the end. This case might not be caught by the restrictions that you suggest, yet conduct described on page 23 is not something we should be encouraging.

Mr. EIZENSTAT. Mr. Chairman, without having had the opportunity to look at this particular provision, I might mention that in the House a suggestion was made of having a 10-percent cash value in the first year as a way of distinguishing it. That was rejected by the staff on the ground, which we don't disagree with, that that is not a sufficient line to draw; that that is still taking a whole segment of potentially abusive investments. And so we are suggesting something in the 4- to 5-percent range. I'd be glad to look at this particular suggestion and make comments very shortly.

Senator CHAFEE. We would be interested in your comments. Perhaps you could send us a letter with some comments within a week or so. We would appreciate it.

Mr. EIZENSTAT. Thank you, Mr. Chairman.

Senator CHAFEE. Addressed to the staff of the committee. Thank you.

[The letter from Mr. Eizenstat follows:]

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March 7, 1984

The Honorable John H. Chafee
United States Senate
523 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Chafee:

When I testified before the Senate Finance Committee on January 31, 1984, you asked me to comment on the illustration set forth in Table 2 on page 23 of the January 27, 1984 pamphlet prepared by the Joint Committee on Taxation describing the provisions of S.1992 which affect life insurance products and policyholders. My client, George W. Karr, Jr., of Karr-Barth Associates, has prepared the attached chart for inclusion with this letter in the hearing record of January 31, 1984. The chart sets forth the cumulative rate of return on cash flow for each year under the terms of the Joint Tax Committee's example. Annual figures, which have been omitted from Table 2 after the tenth year, have been interpolated on a straight line basis.

The Joint Tax Committee example illustrates the costs and values of $500,000 of whole life insurance purchased by a male at age 50 where the policyholder borrows the maximum amounts permitted under current law and uses these borrowings to pay future premiums. As the attached chart clearly indicates, the policyholder's return on his actual out-of-pocket cash flow -- i.e., premium payments net of policy borrowings -- does not reach 10% until the 40th year -- that is, when the policyholder would have attained the age of 90. Since the policyholder would then have substantially outlived his normal life expectancy, the illustration demonstrates that even utilizing the maximum allowable borrowing, a standard whole life insurance policy is not an investment-oriented product. No mere investor would purchase such a contract, under which he could achieve a 10% return on cash flow only if he lived substantially longer than the national average, apart from the insurance protection afforded thereunder.

My clients share your concerns about the abuse of life insurance which occurs when investment-oriented products offering competitive rates of return apart from any insurance protection are marketed as life insurance. However, traditional whole life insurance products, such as the one illustrated in the Joint Tax Committee study which would be a poor investment apart from the insurance benefits, should be protected. Millions of Americans depend upon whole life insurance to provide death protection for their families. The current incentives for the purchase of such contracts, which offer less than a competitive rate of return even taking into account the ability to borrow unlimited amounts according to present law, should be retained.

The approach employed by the House Ways and Means Committee of a $250,000/$500,000 cap is arbitrary and unfounded and should be stricken by the Senate Finance Committee.

If I can be of any further assistance to you or any other member of the Finance Committee or its staff in your consideration of this issue, please do not hesitate to contact me.

Very truly yours,

Stu Eizenstat

Stuart E. Eizenstat

For POWELL, GOLDSTEIN, FRAZER AND MURPHY

SEE:wyp

Attachments

Best personal regards. Thanks for your kind remarks prior to my testimony.

NET RETURN ON CASH FLOW

EXECUTIVE AGE 50 $500,000 FACE AMOUNT

PERMANENT LIFE INSURANCE 10.30% LOAN RATE

YEAR	AGE	NET ANNUAL OUTLAY*	CUM. NET OUTLAY COMP. AT 0.0% INT.	CUM. NET OUTLAY COMP. AT 10.0% INT.	RATE OF RETURN ON CASH FLOW
1	50	$ 14,454	$ 14,454	$ 15,899	0.00%
2	51	14,454	28,908	33,388	0.00%
3	52	745	29,653	37,547	0.00%
4	53	1,489	31,142	42,939	0.00%
5	54	2,233	33,375	49,689	0.00%
6	55	16,687	50,062	73,014	0.00%
7	56	16,687	66,749	98,671	0.00%
8	57	-35,394	31,355	69,605	0.00%
9	58	807	32,162	77,453	0.00%
10	59	730	32,892	86,002	0.00%
11	60	-136	32,756	94,452	0.00%
12	61	-1,002	31,754	102,796	0.00%
13	62	-1,868	29,886	111,020	0.00%
14	63	-2,734	27,152	119,115	0.00%
15	64	-3,600	23,552	127,067	0.00%
16	65	-4,466	19,086	134,861	0.00%
17	66	-5,332	13,754	142,482	0.00%
18	67	-6,198	7,556	149,912	0.00%
19	68	-7,064	492	157,133	0.00%
20	69	-7,934	-7,442	164,119	1.23%

*Based on a 50% tax bracket.

NET RETURN ON CASH FLOW

EXECUTIVE AGE 50 $500,000 FACE AMOUNT

PERMANENT LIFE INSURANCE 10.30% LOAN RATE

YEAR	AGE	NET ANNUAL OUTLAY*	CUM. NET OUTLAY COMP. AT 0.0% INT.	CUM. NET OUTLAY COMP. AT 10.0% INT.	RATE OF RETURN ON CASH FLOW
21	70	$ -9,209	$ -16,651	$170,401	2.39%
22	71	-10,484	-27,135	175,909	3.40%
23	72	-11,759	-38,894	180,565	4.30%
24	73	-13,034	-51,928	184,284	5.06%
25	74	-14,309	-66,237	186,972	5.75%
26	75	-15,584	-81,821	188,527	6.34%
27	76	-16,859	-98,680	188,835	6.85%
28	77	-18,134	-116,814	187,771	7.31%
29	78	-19,409	-136,223	185,198	7.71%
30	79	-20,683	-156,906	180,967	8.05%
31	80	-22,259	-179,165	174,579	8.36%
32	81	-23,835	-203,000	165,818	8.64%
33	82	-25,411	-228,411	154,448	8.89%
34	83	-26,987	-255,398	140,207	9.12%
35	84	-28,563	-283,961	122,809	9.33%
36	85	-30,139	-314,100	101,937	9.50%
37	86	-31,715	-345,815	77,244	9.67%
38	87	-33,291	-379,106	48,348	9.81%
39	88	-34,867	-413,973	14,829	9.94%
40	89	-36,438	-450,411	-23,769	10.06%

*Based on a 50% tax bracket.

Senator CHAFEE. Any other questions? Senator Symms?

Senator SYMMS. Mr. Chairman, I want to ask just one brief general question on the policyholder question. If I hear all of you correctly, what you are saying is that over the years what we have done is shovel money out the door trying to have benefits for senior citizens and so forth. And now in the private sector, if we close down on this we are going to discourage people from taking care of themselves. Is that what you are really saying?

Mr. HOLDEN. Yes.

Senator SYMMS. With the policyholder provisions?

Mr. HOLDEN. Yes.

Senator SYMMS. Anybody disagree with that?

[No response.]

Senator SYMMS. But otherwise you are for the bill?

Senator CHAFEE. Does anybody here suggest that the tax-free group term life insurance for retirees should continue to be discriminatory? In other words, your suggestion is make it nondiscriminatory, but not subject to the $50,000 cap. I think you said that, Mr. Regan, didn't you?

Mr. PERRIN. I said that, Senator. Representing the Association of Private Pension and Welfare Plans, we suggested that that would be one way to curb the abuse.

Senator CHAFEE. Just make it nondiscriminatory?

Mr. PERRIN. Yes.

Senator CHAFEE. For example, everybody could get tax-free coverage based on salary, or on some basis that applied equally to everybody.

Mr. PERRIN. That's the important question. What is the basis? In other words, what's the definition of nondiscriminatory. I don't think that we want to limit flexibility in benefit plan designs overly. And there certainly are different considerations for different segments of the work force. So that would be the only caveat in that regard.

Senator CHAFEE. Well, isn't the term nondiscriminatory a term of art?

Mr. PERRIN. Yes; we would want to havc some of that or creativity left in designing that benefit package.

Senator CHAFEE. Artistic licensing.

Mr. PERRIN. Right.

Mr. EIZENSTAT. Mr. Chairman, I will give you a complete response to this, but on the chart I think it's interesting that you are dealing with a 50-year-old male. It's not until he is 70 that you get an investment return, and not until he is 80 that you get a substantial one. So it doesn't appear to be a particularly abusive situation. But, again, we will try to respond specifically.

Senator CHAFEE. Well, at the age of 58 he gets $35,000.

Mr. EIZENSTAT. Some of it is his own money coming back, which he has put in.

Senator CHAFEE. Sure, but he has also got a tremendous amount of insurance at the same time.

Thank you gentlemen very much.

Senator CHAFEE. The next panel is Mr. Schuh, accompanied by Mr. Groff, Mr. Bashaw, and Mr. Hughes.

Senator SYMMS. Mr. Chairman, I would just like to say that I would like to welcome a friend of mine, Mr. Wayne Schuh, who is an independent insurance agent in Boise, Idaho. And just for the benefit of the committee, his practice ranges from estate planning for ranchers and farmers to the handling of employee benefit programs for some of our largest companies, such as Albertson's grocery chain, the Idaho Power Co., and Symplot Corp.

And Wayne, I might mention, is here at his own expense on behalf of the policyholders he represents. And we welcome you and your colleagues here to the committee this morning, and look forward to what you have to say.

Mr. SCHUH. Thank you.

Senator CHAFEE. Senator Boren.

Senator BOREN. Mr. Chairman, as does Senator Symms, I am also very proud to have constituents on this panel today, among them Mr. Jeff Bashaw of Tulsa, who is an independent insurance agent who specializes in estate planning and life insurance planning for closely held corporations, and small businesses. He has been president of the Tulsa Certified Life Underwriters, and has 20 years of experience in this field. And I think his testimony will be very, very helpful.

And also we have a person who is not directly in the insurance business but who is a small business person, Dick Hughes, also of Tulsa, who is president of Hinderliter. And I might say that he has been the SBA's small businessman of the year. He's been the president of the Young Presidents Organization, International. And he is really an expert across the board in small business. I think their testimony will be very helpful to us in helping us see the impact that this particular provision will have on small business enterprises. So I want to welcome him to the committee, and we are very, very proud to have them.

Senator CHAFEE. Well, gentlemen, we welcome you all here, and we appreciate your taking the trouble to come East to be with us. We will start with Mr. Schuh.

STATEMENT OF WAYNE SCHUH, PRESIDENT, WAYNE SCHUH AND ASSOCIATES, BOISE, IDAHO

Mr. SCHUH. Thank you very much, Mr. Chairman, distinguished members.

In the interest of your time, which I know is growing extremely short, I would like to say that we basically agree with the comments of Mr. Eizenstat, and we would be in support of the deletion of the policyholder issues.

Again, getting to the interest of time, what I would like to do is——

Senator PACKWOOD. Say that again.

Mr. SCHUH. We support Mr. Eizenstat's position. And that we are in favor of the deletion of the policyholder issue.

Senator PACKWOOD. I thought you said nondeletion.

Mr. SCHUH. No; the deletion of the policyholder issues.

I'd like to introduce two other panelists that are here today. Mr. Kornman from Texas, and Mr. Groff from Colorado.

Senator CHAFEE. Now I have got to get everybody straight.

Mr. **Schuh**. All right. Messrs. Bashaw, Schuh, Hughes, Kornman and Groff.

Senator **Chafee**. Thank you.

Mr. **Schuh**. If you have no objections, what I think may serve us well is to turn over immediately to us to answer some specific questions that have been raised or points that have been raised by prior witnesses. And if there are any questions beyond that, we will certainly be happy to answer them. And that may serve your time most expeditiously.

Senator **Chafee**. Well, I think it would be helpful hearing from you on the provisions in the bill which limit the interest deductions on policyholder loans. The suggestion has been made by the major insurance companies that there are not many of these abusive loan policies out there anyway. I ask you gentlemen as veteran insurance agents and salesmen, having dealt with the public, why you feel the restrictions in the bill would be harmful to your business.

[The prepared statement of Messrs. Schuh, Groff, Kornman, Bashaw, and Hughes follows:]

STATEMENT OF A PANEL CONSISTING OF

WAYNE SCHUH, NEAL GROFF, GARY KORNMAN,
GEORGE F. BASHAW, RICHARD HUGHES

ON S. 1992 POLICYHOLDER PROVISIONS

TO THE

SENATE FINANCE COMMITTEE

JANUARY 31, 1984

Good morning. I am Wayne Schuh, president of Wayne Schuh and Associates, Boise, Idaho. My firm is involved in the implementation of employee benefit packages for large and small businesses and advising individuals in regard to their long-range financial security. With me are Neal Groff, president of the Madison Group, Denver, Colorado and Gary Kornman, president of Whitehall Group, Inc., Dallas, Texas. Also accompanying me are Jeff Bashaw, who in addition to being the president of Benefit Concepts, Inc. of Oklahoma, is also a director of the Exchange Bank, Skiatook, Oklahoma, and Richard Hughes, president of the Hinderliter Corporation, Tulsa, Oklahoma, former SBA Small Businessman of the Year, and on the Regional Federal Home Loan Bank Board.

We are here today because we share a deep concern over two of the provisions of S. 1992 affecting policyholders: Section 223, which limits the deductibility of interest on policyholder loans, and Section 224, which will severely limit the amounts of group term life insurance that can be provided to retired employees without subjecting them to tax liability.

POLICY LOAN INTEREST DEDUCTIBILITY

Section 223 of S. 1992 establishes limits on the amounts of interest payments on life insurance loans which may be deducted for federal income tax purposes by individual and business policyholders. This is accomplished by the imposition of specified dollar caps. In the case of individuals, the limit on deductibility is equal to $250,000 ($500,000 for joint returns) times the deficiency rate in effect on the first day of the taxable year. (In 1983 the rate was eleven percent.) In the case of corporations, partnerships, proprietorships or other entities engaged in a trade or business, the limit would be $500,000 times the deficiency rate times the number of qualified insured lives. Qualified lives are, among other criteria, defined as those insured by whole life policies. Loans subject to these limitations include any indebtedness secured by a life insurance, endowment or annuity contract, as well as direct borrowing against life insurance policies.

As we understand it, there were two concerns which prompted the proposal to limit deductibility of interest on loans relating to life insurance. First, the high interest environment of recent years led to the development of products that took advantage of the inherent characteristics and tax treatment of life insurance products but were really investment vehicles which abused the time-honored, socially desirable, and economically necessary purposes for which life insurance was intended. Instead of accumulating cash value only at the rates and amounts necessary to fund the eventual death benefit while keeping the premiums level over the life of the contract, these new vehicles were designed primarily to maximize the internal accumulation of cash value in order to generate positive, tax-leveraged income in amounts large enough to be attractive as investments.

Concern over this type of product is valid. We feel strongly that such vehicles have been correctly identified as investments hiding under a thin veneer of life insurance. We are in agreement with the efforts of Chairman Stark and and Rep. Moore, which led to the proposed definition of life insurance contained in Section 221 of S. 1992. As Treasury Secretary Donald T. Regan observed in a recent speech before the American Council of Life Insurance, the new definition will effectively curb this problem:

> "The principal innovation here is that for the first time, a general definition of life insurance is provided. The role of the definition is to exclude those policies which have too much investment when compared to the amount of insurance protection provided. We're generally satisfied with the way the definition turned out. The tax system continues to encourage long-term savings through life insurance, but the limitations imposed should eliminate the use of life insurance primarily as a tax shelter or as an investment vehicle." (Emphasis added)

We agree. Actuarial studies which we have undertaken confirm that the products identified by Treasury Department and by Ways and Means Committee staff as abusive do not even come close to satisfying the new definitional requirements. This is because the highly leveraged products depended upon unnecessarily high cash values which accumulated early in the life of the policy. Neither disproportionate ratios of cash value to death benefit nor early build-up of cash values will be permitted any longer. Thus, placing a cap on interest deductibility attempts to solve a problem which the life insurance definition will resolve: preventing the use of life insurance products in a manner for which they were never intended.

The second concern which is cited by the advocates of these proposed interest deduction limitations is based upon their ideological opposition to the fact that the cash values which accumulate during the years that a policy is in force (inside build-up) are not taxed currently (although they are, of course, subject to tax if the policy is surrendered). Thus, the argument goes, to allow the interest on loans against such cash values to be deducted is, in effect, to allow a double tax break. Moreover, it is possible to take systematic advantage of tax-leveraging possibilities over the long life of a policy with seemingly lucrative results.

For example, the illustration used by the Joint Committee on Taxation staff in the pamphlet prepared for this hearing (Table 2, p. 23), with the input of an "industry expert", shows that it is possible for a policy taken out at age 50 and remaining in effect for 30 years until the death of the policyholder at age 80 to generate "a cumulative positive after-tax benefit to the policyholder over the 30 years of $155,000." (*Description of Provisions of S. 1992 Relating to Life Insurance Products and Policyholders*, January 27, 1984, p. 24).

Based on this illustration, JCT staff also asserts that "beginning in the twentieth year, the policyholder's cumulative after-tax net outlay would be negative" (p. 24). However, this illustration fails to include a reasonable interest charge for the use of the money. For instance, if a reasonable rate of 10 percent were used, the after-tax net outlay would never become negative. In fact, this illustration is generally forbidden under state law, which requires recognition of the time value of money. Also, while not specified, the table appears to assume a policyholder marginal tax rate of 50 percent. Since most taxpayers are not in this bracket, this illustration shows a higher rate of return than most people would be able to realize.

The staff concluded its summary by suggesting that with death at age 80, "the policyholder would have realized a 12 percent net after tax rate of return on the premiums invested in the policy" (p. 24). The inclusion of the mortality risk portion of the policy in the calculation of the policy investment earnings mixes apples with oranges to achieve an inflated (albeit a modest) rate of return of 12 percent. Moreover, staff appears critical of this rate of return (assuming it is correct). We feel that such a return can only be considered modest in the current economic environment considering the long-term nature of the insurance contract. (Another factor to be taken into consideration is that if the proposed interest deduction cap were enacted, any yield would be necessarily diminished with increasing policy size, thereby making all larger policies less marketable.) In response to the implied criticism of any after-tax rate of return, we must point out that other vehicles with which insurance competes in the marketplace provide for tax free appreciation and full deductibility of interest on loans secured by the asset (i.e., stocks, real estate).

The fundamental flaw with these objections is that they are based on what is possible rather than on what happens. While it is demonstrably true that systematic leverage to attain some degree of positive cash flow is possible, as a practical matter, in the majority of cases it does not occur. People simply do not purchase life insurance for the purpose of borrowing and deducting interest.

Table 2 on page 23 of the Joint Committee on Taxation report on S. 1992, illustrates the Cumulative Net After-Tax Outlays for 10, 20, and 30 years. However, since dying to achieve a profit is unrealistic, a taxpayer is more likely to be concerned with economic benefits accruing during his lifetime. The Cash Rate of Return on the Cash Invested is shown below:

Year	Rate of Return
10	Loss
20	1.2%
30	8.1%

Borrowing illustrations are principally marketing techniques rather than widely used ways to benefit living taxpayers.

Industry-wide policy loan activity figures bear this out. Even over the past several years, when poor economic conditions, high interest rates and high unemployment should have resulted in very high loan activity if the pro-cap proponents are correct, loans were outstanding on only about 28 percent of all policies in force. Of this relatively small percentage it is safe to assume that many, if not most of these loans represent last resort, one-time responses to specific, situational needs for cash rather than systematic borrowing. People do lose their jobs, have children to put through college, have to tide themselves over through periods of slow business, have to get back on their feet after divorces, deaths and other life crises.

Further, if this were truly an abusive situation revenue figures would be attached to the proposal showing that it will increase tax revenues. But, in fact, the opposite is true: neither Treasury nor the Joint Committee have attached any revenue estimates to this provision.

We respectfully suggest that those who are in favor of this proposal have created a problem because they do not perceive the difference between a useful illustration of a policyholder option, to borrow if necessary, and the way the product, once sold, is typically utilized.

It is axiomatic in the industry that people do not buy life insurance -- it is sold to them. This is not surprising, since death although a certainty, is never pleasant to contemplate. The purpose of the so-called "investment element" of a whole life policy is to cover the cost of the eventual death benefit which will be paid out, while avoiding a sharp escalation in premiums as the policyholder ages. (Term insurance often fails to provide a benefit at death because it becomes too expensive to maintain at older ages when claim probabilities are rapidly increasing.

Once a policy has been purchased, the picture changes. Just as it is human nature to resist making a long-range commitment to maintain a whole life policy, it is also human nature to resist depleting the value of that policy through loan activity. Borrowing against the policy is seen as a last resort by most people and businesses, as evidenced by the 25% to 28% loan activity figures cited previously. Agents prefer this because they would rather not assume the heavy administrative burdens that come along with borrowing by their clients. Also, policies which have been borrowed against are more likely to be terminated. Insurers discourage policy loans for two reasons: they lead to increased likelihood of lapsed policies, and to uncertainties in cash flow management.

Thus, while this policyholder option is not used excessively, it has great utility, both as a means of selling whole life insurance, and as a valuable right for those who may, on occasion, need to use it. Life insurance policies are necessary for the eventual financial solvency of survivors, and the continued viability and integrity of farms and small businesses. The ability to borrow against life insurance is an essential element of life policies as illustrated by the following real examples.

SOLELY OWNED FARMING AND LIVESTOCK BUSINESS

The policyholder is the 62 year old owner of a farm and livestock business located in southern Idaho. Over the years, he has accumulated acreage which has appreciated greatly in value. Even though his gross estate is now estimated to be worth between $3.2 and $3.5 million, consisting mostly of land, he is in fact cash poor. The policyholder's wife is deceased. He has two sons who have worked the farm and business all their lives, and who expect to take it over after their father's death.

The purpose of his life insurance contracts, which have death benefits totaling $1.5 million, which were purchased two years ago, is to pay the estate taxes. Given just the appreciation of assets which has occurred over the past two years, it is doubtful that this amount will be sufficient to satisfy estate tax and other financial requirements. While the premium for this amount of whole life coverage at this man's age is large, it is small compared to the looming estate tax. It would be totally implausible for this man to solve his insurance needs with term insurance, since its cost would escalate dramatically rather than stay level.

Even more importantly, it would also be impossible for this family business to tie up substantial cash assets in whole life insurance without the ability to access the cash value through borrowing and to deduct interest on such borrowing. The farming environment is so unpredictable and liquidity is so limited, that if conditions deteriorated even slightly, this farmer could be forced to exercise his borrowing option to either keep the policy in force or meet operational expenses (perhaps for cattle feed).

CLOSELY-HELD RETAIL BUSINESS

The policyholder is the 55 year old sole shareholder of a Colorado retail furniture center employing 25 people. He is married with two adult children. He is in the process of relocating his business to a suburban area to meet competitive pressure. The business has assets of $4,800,000, less debt of $2,500,000. This debt package is necessary to finance the real estate acquisition and to consolidate previous small operating loans. As the bulk of the debt is comprised of real estate financing, the policyholder expects a substantial portion of the loan to be long-term, approximately 20 years.

This policyholder is in the 50% tax bracket. Because of inflation, the value of this inherited business, built up over two generations, has appreciated rapidly in recent years. The policyholder's net worth, which is almost entirely attributable to the probable open-market value of his illiquid business stock, has skyrocketed to about $2,000,000. The company is in a 50% tax bracket for combined federal and state income taxes, and has occasionally experienced cash flow difficulties.

This businessman owns a personal insurance policy in the amount of $50,000. The corporation is required to purchase $2,500,000 of keyman permanent insurance on him to cover the loans. The policy is also intended to serve the long-term purpose of partially meeting future estate tax and estate liquidity needs in order to assure continuity and success of the business after the present proprietor's death. This person owns a second generation business. His father had utilized insurance to assure the business was transferred intact at his death. At age 55, term insurance is not a cost-effective purchase due to its high premium escalation after 10 years. The policyholder would like to purchase additional insurance in the future so that he can bequeath his stock in the store to his son to continue the family business, while also providing liquid assets for his wife and other child.

FARMER

The policyholder is a 65 year old Colorado farmer who is married with two sons and two daughters. Over the many years that he has owned and built up the farm, he has incurred debt for the purchase of land, livestock, and equipment.

He is planning on augmenting his present $25,000 personal insurance policy with an additional $3,000,000 permanent policy to cover an outstanding bank loan for land purchased, and to provide for estate liquidity, estate taxes, etc. Without this coverage, his survivors would have to sell the farm, probably for far less than its value at a forced sale, to pay off the real estate loan and the farmer's estate taxes. The farmer wants to make sure that his sons do not lose the farm. He also wants to provide for his wife and give his daughters an inheritance comparable to that of his sons. However, he could not afford to commit himself to the cost of this insurance coverage without knowing that he has the option of borrowing against the cash value to overcome any unanticipated problems arising from high operating expenses, income shortfalls, or limited cash flow. Term insurance would not be feasible at his age because of its high cost and lack of flexibility.

At a time when record numbers of farms are going to the auction block for a fraction of what they are worth, it seems particularly ill-advised to deprive their owners of the kind of financial flexibility illustrated above.

CORPORATE EMPLOYEE BENEFITS PLAN

A small western power company has an employee benefits plan which covers about 360 employees whose jobs run the gamut from lineman to chairman of the board. In recognition of the contribution that long term employees have made to the success of the company, the plan is designed to reward both position attained and years of service rendered. About 280 of the 360 participating employees have been with the company for 15 or more years and have reached the age of 50. Most of these individuals are not likely to attain upper management positions. Their salaries range from $27,500 per year to the chairman's salary of $180,000. Most salaries in the group are between $27,500 and $50,000.

In reviewing its pension benefits prior to the design of the current plan, the company noticed that most participants were electing a maximum pay-out option at retirement. While this maximized each employee's lifetime benefit, it left surviving spouses with considerable economic burdens at the employee's death. A major objective was the implementation of a death benefit only plan which would equalize the retirement benefit for the employee and the post-death benefit for the surviving spouse.

Like many corporations, this company needs to and wants to provide adequate benefits to its employees, but must arrange to do so in a way that will not irrevocably tie up large amounts of money should occasions arise when there are cash flow problems which must be responded to on a short-term basis. In such instances, were it not for the policy loan option, a choice would have to be made between 1) not providing the benefit, 2) letting the plan lapse, or 3) paying the premium through cuts in stockholder dividends or increases in rates. While it is not the intent of the company to borrow against its policies, it would certainly not have adopted this plan without such an option, considering both the long-term nature and size of this commitment to its employees.

In his statement before the ACLI which is quoted earlier in this testimony, Treasury Secretary Regan observed that "the tax system continues to encourage long-term savings through life insurance." Congress has shared this view for a very long time. Since 1913 -- 71 years -- inside build-up has been allowed to accumulate without tax as long as the policy is in force. Policy loan interest on whole life contracts has been deductible as long as any interest has been deductible.

We are convinced that the current tax treatment of bona fide life insurance products is appropriate and should be retained. It is a reflection of a national policy that has proven itself over the years to be good for individuals, good for the economy, and good for our country.

GROUP TERM LIFE INSURANCE

Section 224 of S. 1992 proposes several changes to Section 79 of the Internal Revenue Code governing the tax treatment of group term life insurance.

For the first time, a tax on this benefit would be imposed on retirees, except for the economically obsolete $50,000 exclusion that currently applies to non-retired employees. This means that the employer's premium payments for group term coverage of more than $50,000 will be treated as income taxable to the retired employee.

Since most group term plans provide some coverage for retirees, we question the social and economic soundness of a decision which would impose this economic burden on large numbers of individuals at a time in their lives when they can least afford it. This, indeed, is the time when their need is greatest, particularly since this is the time of life when most insurance claims are actually paid.

We strongly urge that the present law be retained with regard to retired employees if Congress considers a nondiscrimination rule to be necessary.

In an effort to avoid undue hardship, there is a grandfather rule to protect plans in existence as of September 27, 1983. However, even JCT staff has pointed out in its pamphlet prepared for this hearing, "although on its face this provision grandfathers existing plans, several questions are left unanswered." These "unanswered questions" raise real and serious technical problems which must be corrected if the law is to operate fairly and consistently.

The whole proposal is fraught with undue technical complexities which can only lead to the inappropriate termination of some plans. Because the proposed changes to Section 79 have not been thought through as to social policies and technical soundness, it is up to this Committee to either find the time to do so now, or drop the provision until it can receive the consideration it deserves.

Senator BOREN. Mr. Chairman, I noticed in their written testimony they have some specific examples of how it might affect a farmer who has used whole life or a small business person who has used small life. And I think that would be real helpful if they could maybe give us a couple of specific examples.

Senator CHAFEE. That's right. Which of you gentleman would like to do that?

Mr. KORNMAN. What we would like to do, if it would be convenient with you all—we know you are under a shortage of time, and you do have that written testimony—could we just talk about a few of the points that have been raised here and try to bring you up to date on our opinions of them?

First of all, there are 482,900 licensed life insurance agents in the United States today or approximately that many according to the Department of Labor. Of that, the NALU represents 127,000 or slightly more than 26.3 percent.

The AALU, has 1,100 members and represents less than 0.2 percent of the life insurance agents in the United States. And in the AALU itself the first approach was a corrider to try to get the Treasury to take an approach that would do away with the abusive products and keep permanent life insurance a viable thing.

We also represent a large number of policyholders who have had absolutely no voice in this matter. And as a part of the negotiations with Mr. Stark and Mr. Moore's committee, the National Association and the AALU agreed not to give the policyholders themselves any notice of these proceedings. So we would just like to first tell you who have been the participants in what has come so far.

Mr. **Groff**. Senator, you asked a previous witness a question concerning the example of maximum borrowing on a life insurance policy on page 23 of January 27, 1984 report of the Joint Committee on Taxation Staff. I would like to comment on the question you raised.

First of all, when they started on this issue in Washington there were, in fact, some significant abuses in four- or five-to-one shelters that Mr. Chapoton addressed this morning. A four- or five-to-one shelter means that if you put a dollar in, you take a deduction of $4 or $5. The way to look at a shelter according to any financial analyst would be cash on cash. The example on page 23 shows a cash on cash negative rate of return through 10 years, a rate of return at year 20 of 1.2 percent, and a rate of return in 30 years of 8.1 percent.

Next I would like to address exhibit 1 of today's testimony by Mr. Chapoton. It's the very last page, the front side of that. Once again, financially analyzing the cash on cash, it takes 19 years for that to break even as a tax shelter which is 1.8 percent, and this does not take into account the 20-percent alternative minimum tax. I do sell life insurance in these types of situations where the cases are large to protect farmers, and closely held businesses that continue to employ people and pass their asset base from one generation to the other. I submit to you that in the real world, a client would never buy this with those assumptions on this page because his advisers would point out the low return and the alternative minimum tax, which is another 20 percent. And the yields—I will also give you the runout on the yields.

First of all, a man 45 does not have a life expectancy to age 95. He has a life expectancy between age 75 and age 80. Mr. Chapoton's example does not yield a positive return until age 64, and this return is only 1.8 percent. At 65 years, it's 3.58. If he is willing to keep it in force from 65 to 75 it goes to 11.32 percent cash on cash. If he keeps it to age 80, which is past his life expectancy, the yield is 12.77.

I would like to comment on two other points that were addressed here today concerning retirement. I would submit to you that the income of the average person in retirement is decreased by an excess of 60 percent.

This time I would like to turn it over to my fellow panelists.

Mr. **Hughes**. Mr. Chairman, as Senator Boren said, I'm a user, a policyholder, so I'm unfamiliar with all of the policies that are out there and available. But I am familiar with the investment aspect, the savings aspect, and the risk aspect of policies.

I would just like to make three comments to the panel regarding the impact of the taxation to the policyholder. First, I believe that many of you are familiar with the recent MacKenzie study which indicates just a small mid-range growth company has an effective tax rate of about 37 percent, which is about 10 percentage points above that of major U.S. corporations. And yet I think it has been proven that it's the small businesses of this country that increase the employment, that pay the taxes, that create the innovation and that give us the backbone of growth.

The second point—and one that I think addresses the equity issue that the Secretary commented on—is that I think you are familiar with Senator Tsongas' look at the cost of capital study in a competitive environment that George Gasopolus used. That study shows that we are in a cost of capital deficit in the world market—and I would also suggest to you that the small business is in a cost of capital deficit to the major industries in this country.

You have got to look, in my opinion, at how business uses ordinary life insurance. First, we use it to capital. I've been in business 24 years and I have never been able to borrow money without a personal life insurance policy.

The Secretary commented that the provision that would allow you to go with more than one person would be sufficient. I would love to have my banks take 13 of my employees at $250,000, but they don't seem to do that. They want $3 million on myself as an individual or $5 million against the loan.

They are looking to the entrepreneur, the individual businessman or the private businessman to support that borrowing, and not to all of the employees in the company.

The small businessman also uses that policy as security. In the downturn of the economy, we do, as Senator Boren knows—we are in the oil business, and in 1982 we went through cultural shock. The industry fell out of bed on us. And those of us that had developed cash values used them to see us through some very tough times, as did some of our employees.

If you take the security element and you eliminate the tax deduction, you, in effect, have increased the cost of capital of all independent farmers, the small businessman and the individual who is already at a tax disadvantage in the economy.

Senator PACKWOOD. Let me ask you a question. You have got good experience in small business. Most of you are in a medium size business. Have you got any rampent evidence of systematic borrowing for personal purposes in these small businesses? I agree with you. I know what it takes to get going and get the 15 or 20, or 25 employees. And you are absolutely right. The bank is not going to loan on the value of each of those employees. If you can't cover that, you are not going to get the money you want.

As a pattern do you find medium-sized businesses are bilking this system?

Mr. HUGHES. Senator Packwood, I have never seen that as an abuse. I'm sure there are abuses in the industry. But the small businessman is more interested in growing his or her business. The President cited Barbara Procter as an example. And if you saw "60 Minutes," she only could get her loan on her ability. And the banker called the advertising agency and said what's she worth. We. have never seem that in our area to where it is abusive. Small businesses grow. I might add that in looking at the proposals, our required return on capital is 30 percent just to stay in the competitive game with the majors, and to hold good employees. We cannot pay in our area the same wage scale that McDonnell-Douglas pays, for example. And could not be competitive. So we will use those things to hold the employees as well. So we don't see abuses. I'm sure there are some.

Senator Packwood. What happens to small business if we put this limit on and you are trying to raise capital?

Mr. Hughes. Well, I think you are going to have a harder time. You, obviously, can use term policies, but it is just going to cost you more. And you don't have the guarantee then of insurability on the individual.

Senator Packwood. Thank you.

Mr. Schuh. To pick up on the question that you just raised, Senator, he systematic borrowing is an overused argument against us. And, in fact, you also touched on another issue, that being the cap. It forces our farmers and our ranchers, and our small business people into a situation of future uncertainty about the tax treatment of life insurance that makes it very difficult for people who look to those policies that we sell as a source of protection and an available source of funds in a time of need. And if that opportunity is limited to him—and it would certainly seem that if Mr. Chapoton has his way in the future it will be even more critically limited—that we are going to be in a very difficult strait when it comes to advising our clients and having those policyholders able to make prudent and financial business decisions in the future.

Senator Chafee. Well, the cap does not seem all that onerous. Furthermore, it seems like no cap at all, since it's cumulative. Are you finding the cap that onerous?

Mr. Schuh. Yes, I do, Senator.

Mr. Hughes. Senator, I would like to comment. As a business person, I find it onerous for two reasons. As I said, you can't cumulate when your banker is looking to the individual and that individual's talent. Second, just as an example, NASDEC, which is the depository of the small public companies, has a minimum equity requirement of $1 million to list and $2 million of assets. So in most growing businesses today, a $250,000 cap would limit the capital formation as they started to grow.

Senator Boren. It's not at all unusual to have to go in for amounts of $2, $3, $4 million in a business we would call small, especially one that is growing and innovating, and to have that requirement of personal insurance protection on the entrepreneur.

Mr. Hughes. That's correct.

Mr. Kornman. Senator Boren, could I say something in support of what you just said?

Senator Boren. Sure.

Mr. Kornman. We write very large policies for primarily estate tax business purposes. And our actual experience is—let me tell you how a client looks at it. First of all, a client looks at it that what happens if he pays his full premiums as they are due to the insurance company. No. 2, what would happen if he is to pay his premium for a period of years, and then wants to take a paid-up policy and discontinue paying. And, third, what happens if his business, which has happened in many segments of our economy, has a difficulty and he, for whatever reason, cannot come up with the cash to pay the full premium.

At the present time, approximately 80 percent of our policyholders have no loans and these will be in multimillion-dollar policies. And I can honestly say I don't believe there is more than one, maybe two, that have borrowed consistently on their life insurance contract. I believe, No. 1, that the abuses have been cured by the new definitions of life insurance which eliminates policies of very high cash values. And, No. 2, that is what is really a sales illustration method is being taken as being something that is a flagrant, gross abuse when the reality of it is not happening.

One of the things that Representatives Stark and Moore said was that when they polled the companies, they didn't find all these loans. That was the reason why they said, gee, this affects a very small percentage of the policies. The fact of the matter is that those huge loans or this arbitrage are not there. It's merely a way for a business person or any other reasonable human being to know what options they have got in a program that may take 20 or 30 years.

Senator CHAFEE. Well, as you know, you can use that argument both ways though. If there are not many of these loans out there, preventing them can hardly be all that harmful.

Mr. KORNMAN. The fact that that option is taken away would have the businessman in the position of not having some way out if his business has a reversal. And he will not enter into that transaction in the first place. I mean I don't believe any of you would enter into a transaction that obligated you to pay money for 30 or 40 years with no way out if something went wrong.

Senator CHAFEE. Let me ask a question of you gentlemen, and anyone on the panel can answer it. A business person who needs life insurance to obtain a bank loan can get term insurance; can he not? What's the problem there? Too expensive?

Mr. BASHAW. I think one of the problems you have with supplying term insurance for a bank loan—let me just give you an example. I have a grain distributor in Oklahoma, Ok y Grain, who was with Garbey's for many years, and went into business for himself at the age of 63. The bank required an $800,000 loan. We wrote term insurance and the premiums started skyrocketing. He was forced to convert to permanent insurance because of the premium level. So when you look at the cost of term insurance——

Senator BOREN. How much would he have saved in that example that you gave, $800,000? And he tried it at term and you converted it to whole? How much was the variation in cost? We have been very much tuned to the need for capital formation, and understood why we had to have that if we are to compete internationally. I sat in on some of Senator Tsongas' seminars where Dr. Gasopolos talked about our deficit on the competitive ability in terms of the cost of capital; particularly, to the businesses that are growing and expanding—high tech and small businesses that are innovative. What is the difference? What would be the difference? In that case, how much did the cost go up?

Mr. BASHAW. I think it is a twofold problem. One is the cost differential because at that age the premium is escalating rapidly and I will let somebody else here answer that. But the real problem is how long do you need the insurance. That's the real problem.

Mr. KORNMAN. The industry can give you statistics that show that very little term insurance ever pays a death benefit. And the reason is because the probability death as you go down the road, whether it's the estate taxes or buy-sell agreements or loans whatever, as you go down the road, the premiums become so prohibitive that you stop and you forfeit all the premiums you paid in the past, and you end up with no life insurance coverage. Unfortunately, that's the pattern that you find on term insurance.

Senator SYMMS. Mr. Schuh, I notice in your testimony you have some examples in the back of people that would be affected by this. But I want to look at it from the point of view of, say, the employee of one of the companies that has a benefit. How high of a salary are some of these people earning that would be affected by these policyholder provisions?

Mr. SCHUH. The salary range is $27,500 to the chairman at $180,000. The example that you are pointing out has approximately 360 people covered under the plan that would, in essence, supply death benefit at the death of the employee after he has retired. Over two-thirds of the people who are covered under that particular plan are individuals who earn in an income range of $27,500 to $50,000.

Senator SYMMS. Two-thirds of them?

Mr. SCHUH. Yes.

Senator SYMMS. So you are not talking about real high income people out here in other words?

Mr. SCHUH. Absolutely not.

Senator SYMMS. But how much of a discouragement to promoting this kind of a retirement program will this be?

Mr. SCHUH. The cap that seems that to be so gracious, if it is enacted, a company like this has to look at two situations. One, it wants to provide reasonable benefits for people who have served a long time and have achieved a certain age in that company and contributed to the profitability and the success of it. The other side of it is they have to look at the individuals who own stock in that company, and in this case pay rates to that particular company.

If they were not allowed to have some kind of a source to recapture the cost of that plan, and an ability with the insurance contracts to be able to access those funds, it would be prohibitive. And I would say that the two-thirds of the people who now enjoy or will enjoy a slightly increased benefit in the retirement would not have it.

Senator SYMMS. So if these are implemented into law what we might anticipate 4 or 5 or 10 years from now is a bigger pressure on the public sector to provide some kind of benefits to people for whatever reason that are in a disadvantaged position.

Mr. SCHUH. That's correct. And, again, as you well know, in this particular case a utility is not known as being a particularly high paying industry, and yet that utility is an extremely well run one. And in order to attract and keep talented young people and keep them around there to the age of 50 when that benefit begins to accrue to them, they would have to do something, and ultimately that cost would obviously have to be passed onto the rate payers.

Senator SYMMS. Thank you very much.

Mr. SCHUH. I would like to make one other point since you have touched on something that is very special to me. The company that he is talking about, again, has a lot of people who are not very high salaried. And my business practice, as Senator Symms introduced me, is farm, ranch community and employees of these large companies. I am going to refer to a statement that was made, and I truly resent it and I know that the clients that I represent would as well. I'm not here as a greedy insurance agent. And I'm not here representing the wealthy taxpayers who are trying to avoid paying taxes. I would dare say that most of the people that we do work for either are the backbone of this country in providing food for table or are the backbone of this country in being the work force. And the benefits that we provide in the form of insurance protection and perhaps in some cases retirement benefits or enhanced retirement benefits after that individual worker has died or protection to pay estate tax so that a farm or a small business can continue to run profitably and employee 15 or 20 people, that is the not the profile of a greedy taxpayer who is looking to avoid paying taxes.

And I would like to make that correction for the record.

Mr. GROFF. I would like to add to that in our closing of our panel. One, I submit to you that if any person came to you with any investment that it took you 18 years to get any money back at all, under an ideal tax bracket situation which is 50 percent, and after 19 years you got 1.8 percent, you wouldn't even have to be a CPA to tell me you weren't interested in that deal.

Second, when you put the alternative minimum tax in there at 20 percent, it will never turn. And as you can imagine, Treasury gave the worst situation here of the products they could find under the new definition. And I submit to you that if I or any other shelter analyst—not an antipermanent life insurance analyst—were looking for a shelter we would analyze this from a shelter standpoint. You would have no interest in this at all.

Thank you very much, Senator.

Senator CHAFEE. What is your reaction to the proposal that tax-free group term life insurance for retirees be nondiscriminatory? How many are for that? Raise your hands.

[Showing of hands.]

Senator CHAFEE. Any other questions? Thank you very much, gentlemen, for taking the trouble to come. And we appreciate it. This concludes the hearing.

[Whereupon, at 12:26 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

Allstate

STATEMENT OF
ALLSTATE LIFE INSURANCE COMPANY
TO
SENATE FINANCE COMMITTEE
U.S. SENATE
ON
S. 1992

Date: January 31, 1984

Submitted By:

Herbert E. Lister
President

Allstate

Allstate Life Insurance Company appreciates the opportunity to present its views on S.1992.

Allstate Life has used a standard of fairness....fairness to our policyholders, fairness to the companies and fairness to the public....as the criteria by which life company tax legislation should be judged. The basic provisions of S.1992 relating to taxation of life insurance companies meet that standard. Other provisions do not. Permit us to elaborate:

1. the Bill appears to be fair to the public in that it produces an estimated $2.9 billion tax revenue in 1984. However, if that revenue level is raised by the Senate, the Bill will not be fair to the life companies because it will aggravate an already unfair competitive situation vis a vis other financial institutions;

2. the Bill is not fair to present or future policyholders because Bill Section 224 would impose burdensome new taxes on retirees for certain employer sponsored group life insurance plans. The effect of this tax will be to cause

employees to reject much needed life insurance because of their inability to pay the taxes. This provision is particularly unfair because additional tax revenue is expected to be negligible. This provision should be deleted from the Bill;

3. certain technical amendments need to be made. Two provisions are particularly unfair:

    a. Bill Section 217(d) affords a benefit to a select few companies based on their state of domicile. That provision should be extended to comparable fact situations, wherever the company is domiciled;

    b. a proposed amendment to I.R.C. Section 811(a) regarding accounting rules is being interpreted, according to the report of the Staff of the Joint Committee, as giving primacy to Federal tax accrual rules over State statutory accounting rules. We disagree with that interpretation. Unless this issue is resolved, there may be a steady stream of litigation for years to come.

We support the Stock Company Information Group's statement on other technical amendments.

4. S.1992 appears to be fair to the life industry in that it is expected to produce a balance between the stock and mutual segments of the business;

A detailed treatment of these points follows.

Except as noted above, S.1992 has the full support of Allstate Life. We urge the Senate to enact this measure, with the changes suggested herein, at the earliest opportunity and with an effective date of January 1, 1984. We need certainty of taxation in order to be able to price and market our products.

Total Tax Burden and Competitive Implications

It is anticipated that the proposed legislation will raise approximately $2.9 billion in revenue from the life industry in 1984. We believe that this is an acceptable level of revenue. Viewed from several different aspects, however, an increase in this level seems entirely inappropriate. First, in light of total corporate income tax receipts, the life insurance industry will be

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paying more than its fair share. The industry's percentage of the total corporate tax burden will increase from 2.5% in 1959 to a projected 3.6% in 1984. Such an increase could be justified if the industry's rate of growth had kept pace. In fact, it has not.

According to the 1982 Annual Report of the Minneapolis Federal Reserve Bank, between 1959 and the end of 1981 the banking and thrift industry's share of the financial asset market held relatively steady at about 60%, while the life insurer's share of that market dropped from 24.7% to 16.9%. The General Accounting Office Report of September 18, 1981 (covering the years 1960-1976) indicates that, as a percentage of assets, life insurers have since 1965 paid more in taxes than banks. The average tax in terms of percentages of assets for the years 1970-76 was about .65% for insurers and .15% for banks. From 1972 to 1976 life insurers paid more taxes in absolute dollars than did the banks. In contrast to the increase in the percent of total corporate revenue paid by the life industry, the largest class of financial intermediaries - the commercial banks - has seen its share of the corporate tax burden cut in half over roughly the same time frame. In 1960, the commercial banks paid 6% of the total. By 1978, this had dropped to under 3%.

Bill Section 224 - Group Term Life Insurance Purchased for Employees

Currently, the cost of group term life insurance coverage in excess of $50,000 provided by an employer for an employee is taxable to the employee. Life insurance furnished to retirees and disabled persons is not taxable. For persons not yet retired and who are over age 64, the taxable income is computed on the assumption that the value of the insurance is the same as it is for attained ages 60-64. Bill Section 224 proposes to tax retirees on such insurance, with the exception of a very diluted "grandfather" clause. Further, so called "top-heavy" plans would be taxed based on the *actual* cost to the employer rather than the "cost" as specified in the current law which *caps* the cost at that for attained ages 60-64.

We feel that Bill Section 224 should be deleted because its effect will be to put unfair financial pressure on present and future retirees. Appendix A (attached) shows selected examples of the dollar impact which S. 1992 will have on retirees and on persons still working. The tax burden created will cause retirees to reject these plans which will then be discontinued, putting additional pressure on Social Security and pension plans. The Social Security System has recently undergone a serious fiscal crisis, and there are many who believe the crisis will emerge again. In response to this problem, Congress is encouraging individuals to save and help provide for their retirement through the expansion of IRA and Keogh eligibility and upper limits. In fact, Bill Section 231 would further encourage savings by allowing nondeductible contributions to an IRA. In contrast, Bill Section 224 frustrates the objective of encouraging people to provide for their retirement.

For retirees, the amount of group term life insurance that could be provided would be severely limited at a time when there is still a need for coverage and replacement with individual policies is prohibitively expensive. Bill Section 224 (c)(2) attempts to provide some relief by "grandfathering" plans with respect to those individuals and coverages in effect on September 27, 1983. Since most plans are based on formulas (that is, the amount of coverage is a function of salary) rather than on fixed dollar amounts, this relief provision would be unfairly diluted. Also, since new employees could not enter existing plans, discrimination would be created within employee groups. The problems created by these irrational and inconsistent results will threaten the existence of many well-established plans.

The current law recognizes the social desirability of persons over 65 having life insurance. This serves to reduce the pressures on

Social Security and retirement plans. For a retired married couple, life insurance permits them to use more of their savings while the insured is alive. When the insured dies, the life insurance proceeds can be used by the surviving spouse for his or her financial needs. Also, the current law recognizes that a full tax on life insurance premiums, such as is proposed by S.1992, would result in many retired persons rejecting the coverage because they could not afford to pay the tax. The "capping" of the cost of coverage in the current law should continue for all group plans.

The proposal could have other undesirable effects. Presumably, younger employees, whose contributions to group life plans may exceed the cost of individually purchased life insurance, would decide not to participate in group life plans which tax post-retirement premiums since they would receive no compensating benefit for the "excess" contributions made during their younger years. This would drive up the cost of protection for older and retired persons and threaten the continuance of these socially desirable plans for active employees.

Bill Section 224 is not just a tax on fringe benefits designed for a select few. In fact, it will impose a tax on large numbers of future retired people, most of whom should not be classified as rich. Once retired, virtually everyone's income is reduced and quite often, the reduction is quite substantial. Further, once retired, the ravages of inflation continue to diminish the purchasing power of the retired. It is difficult to understand the need to impose this tax on retired persons. Obviously, the problems inherent in such a change in the existing law outweigh the possible benefits. This is especially true in light of the fact that - according to Administration and Congressional budget estimates - this change would produce little revenue.

Technical Corrections

Bill Section 217(d)

As mentioned, there are two suggested technical corrections which we feel compelled to address. The first of these issues involves the transitional rules under Bill Section 217(d). The other is in reference to a minor change in wording, contained in proposed I.R.C. Section 811, from language contained in the 1959 life company legislation.

Currently, the transitional provisions contained in Bill Section 217(d) allow relief to only a select few companies. This relief applies to certain life insurance company acquisitions where the basis in the target life company assets are determined under either I.R.C. Section 334(b)(2) or Section 338. Companies across the nation fall into this category, yet the relief allowed under Bill Section 217(d) applies to only certain companies which are both (1) domiciled in Alabama, Oklahoma, or Texas and (2) mentioned by name in the Joint Committee on Taxation's report.

Allstate is one of those companies which would stand to benefit from this relief provision. In its present form, however, Allstate will be excluded from the group which will be allowed relief solely due to the fact that it is not domiciled in one of the three states named in the provision.

Proposed I.R.C. Section 811(a)

The other technical correction of particular concern to Allstate involves the wording change to one of the accounting provisions of the proposal. We believe that nothing of substance is accomplished by this change. The 1959 life company tax legislation contained a provision almost identical to the one contained in proposed I.R.C. Section 811(a). Specifically, the pertinent part of the accounting provision contained in the 1959 Act begins, "Except as provided in the preceding sentence, ..." The Bill's comparable provision (see Bill page 48, lines 13-14) begins, "To the extent not inconsistent with the preceding sentence or any other provision of this part...". The emphasis of these two phrases are essentially the same.

Literally read, the proposed language in no way changes Subsection 818(a)'s requirement of the accrual method of accounting for life insurance company tax computations where applicable, and, in all other areas, the annual statement method of accounting. Incredibly, however, the proposed change in wording, unsubstantial though it appears, is interpreted in the October 5, 1983 "Comparison of Present Law and H.R. 4065," prepared by the Staff of the Joint Committee, to have the following dramatic result:

> "Federal tax accrual accounting rules would have primacy over State statutory accounting rules. State rules would apply to the extent consistent with, or required by, Federal tax rules."

We believe that the wording change in proposed Section 811(a) from existing law is unwarranted. Potentially, such a change could be the source of an unnecessary spate of endless future controversy and litigation over the true meaning of this new language. The staffs of Ways and Means and Joint Committee on Taxation have spent countless hours analyzing the method by which life insurance companies measure taxable income, and they have suggested specific changes in those areas which they felt needed improvement. Allstate does not object to these specific changes. We do, however, object to a change to the accounting provisions to which the staffs - after careful analysis - found no specific change necessary. Clearly, such a wording change can only result in confusion and needless controversy while accomplishing no positive end. For these reasons, we urge this Committee to change the wording of proposed Section 811(a) back to that found in the current law under Section 818(a).

Thank you for your attention to our comments.

Respectfully submitted,

Herbert E.

Herbert E. Lister
President
Allstate Life Insurance Company

Allstate

Appendix A

TAXABLE INCOME FROM GROUP LIFE INSURANCE
Selected Examples

Assumptions:

- Employer Pays Entire Premium
- Employee has $100,000 of Group Life Insurance

Employee Age	Employee Retired?	"Key Employee" Plan	Estimated Taxable Income Current Law*	 S. 1992
42	No	No	$ 102	$ 102
42	No	Yes	204	204**
57	No	No	450	450
57	No	Yes	900	900**
67	No	No	702	702
67	No	Yes	1,404	3,288**
67	Yes	No	0	702
67	Yes	Yes	0	3,288**
77	No	No	702	702
77	No	Yes	1,404	8,500**
77	Yes	No	0	702
77	Yes	Yes	0	8,500**

* Effective for taxable years beginning in 1983.

** Actual cost of insurance determined from certain commercial reinsurance rates.

AMERICAN
ASSOCIATION
OF RETIRED
PERSONS

25 YEARS OF SERVICE

January 26, 1984

Mr. Roderick A. DeArment
Chief Counsel, Senate Finance Committee
Room SD-219, Dirksen Building
Washington, D.C. 20510

Dear Mr. DeArment:

Please include the following statement of the American Association of Retired Persons in the record of the hearing on S.1992, the Life Insurance Act of 1983, which was held on January 31, 1984.

The American Association of Retired Persons appreciates this opportunity to comment on the Life Insurance Tax Act. AARP is concerned over the provision which would amend section 79 of the Internal Revenue Code to require that the cost of employer carried group-term life insurance (to the extent it exceeds the cost of $50,000 of such insurance) be included in the gross income of retirees.

A substantial number of employers make it a practice to extend group life insurance to retired employees, albeit often at somewhat less than full preretirement coverage. The proposed legislation will saddle many of these retirees with an additional tax burden. In light of the precarious economic status of many of today's retirees and the newly imposed tax on social security recipients, an additional tax on older Americans is ill-advised.

Many retirees live on fixed and relatively limited incomes, and this is likely to be the case for future retirees who would not be protected by the inclusion of a grandfather clause in the legislation. Most private pensions are not indexed for inflation and therefore do not provide adequate retirement income. Social security benefits have recently become subject to taxation. While the current threshold limits protect less well off beneficiaries, they too are not indexed, making it likely that in the future even beneficiaries of modest means will be subject to the tax. It is clear that many of the elderly simply cannot afford additional tax liability.

Arthur F. Bouton
AARP President

Cyril F. Brickfield
Executive Director

National Headquarters 1909 K Street, N.W. Washington, D.C. 20049 (202) 872-4700

From the time of its inception, retirees have not been subject to the provisions of section 79. Today workers who are approaching retirement no doubt expect that the cost of group life coverage extended past the date of retirement will remain non-taxable. Many of these individuals have little control over whether they will continue to receive employer paid coverage after retirement. Even for those who do have the option, the available choices are undesirable. Either they must subject themselves to additional taxes after retirement, or they must forego the continued financial protection of group life insurance that would be made available to them in their old age. Either scenario presents a hardship for tomorrow's retirees.

There seems to be little benefit to be derived from this proposed change in the tax law. The revenue effect of this provision would be negligible and would be far outweighed by the burden created by the likely discontinuation of valuable post-retirement coverage. The nation's elderly have already made sacrifices during these difficult economic times. To require this additional sacrifice, particularly when so little will be gained by it, is plainly unfair.

The provision affecting employer carried group-term life insurance is by no means an integral part of the scheme of S.1992, a bill dealing primarily with taxation of the life insurance industry. Therefore it could be dropped with no consequence to the overall bill. This is the course of action the Association urges the Committee to follow.

Sincerely,

Peter Hughes

Peter W. Hughes
Legislative Counsel

PWH:DS

STATEMENT TO SENATE FINANCE COMMITTEE
on
STARK/MOORE LIFE INSURANCE TAX BILL (S.1992)

by

THOMAS M. DABBS, CLU, ChFC
Post Office Box 147
Sumter, South Carolina 29151

(803)-773-8066

STATEMENT TO SENATE FINANCE COMMITTEE
on
STARK/MOORE LIFE INSURANCE TAX BILL (S.1992)

The budget deficit of our country should be a concern of all of the citizens of this nation, not just of the members of Congress. If each of us who are concerned would express one or two constructive ideas, then you who have the responsibility of making decisions will be better able to accomplish the desired objectives.

Life insurance has two unique festures:
1. Cash accumulations during life which are not subject to income taxes.
2. Death proceeds which are not subject to income taxes.

Our current laws permit the deductibility of interest on life insurance policy loans, providing four out of the first seven premiums are paid without loans. Life insurance companies have designed policies to take advantage of this feature and the insurance contract becomes a vehicle which changes an after-tax premium payment to a payment of interest which is deductible. The policies loans can be increased to give a tax-free cash payment equal to 50% of the interest payment which is the reason such contracts have been given the name "Government Pay All Plan".

Some newer products provide higher interest payments on policy loans--a tax deductible item--but give a credit back to the policyowner of tax-free cash value accumulation equal to 3/4% less than the rate paid on the loan. Thus, a 12% loan charge would be fully deductible, but a tax-free credit of 11¼% would be given on the outstanding loan.

The net result of these transactions is that the policyowner obtains interest deductions, yet by increasing the policy loans each year, he receives a positive cash flow which is a deductible item by the insurance company as a necessary reserve. At death, the policy loan is repaid by the tax-free life insurance proceeds.

The government loses revenue in two ways:
1. The policyholder shows less taxable income due to an increase in interest payments.
2. The insurance companies show less taxable income due to the increase in reserves required to fund the cash values of the policies.

Congress has felt the need to limit the deductibility of contributions for qualified pension and profit-sharing plans so that the retired employee will be limited to $ 90,000 of income provided through such plans. However, the new insurance products permit an employer to selectively contract with key personnel for deferred compensation plans and currently deduct the funding of such plans through interest payments.

The current Stark/Moore House bill would permit interest deduction on policy loans of up to $ 500,000. Assuming interest of 10%, this would permit an annual deduction of up to $ 50,000 per employee selected for a deferred compensation plan.

If this limitation is allowed to stand, then Congress should also permit added annual contributions of up to $ 50,000 for any employee covered under a pension of profit-sharing plan.

There are many ways to address this abuse; however, there are two which would be simple--and we do need to simplify our laws:

1. Deny deduction of any interest paid on a life insurance policy;
2. Or, classify the purchase of life insurance as an investment property and the limitation of such deductibility would be $ 10,000 annually plus any net taxable income thrown off by the policy. You would need to have this apply to both corporations and individuals, as the current limitation on the deductibility of interest on investment income property does not apply to corporations.

Companies and individuals who have purchased these policies are very sophisticated and have the best of legal and accounting advice. These advisors should be made aware that the government will move to stop these abuses so they will caution clients against making such purchases. In reality, these advisors encourage the purchase of such products with the idea that all existing plans will be "grandfathered". By grandfathering existing plans, you would be encouraging the purchase of every such scheme which will develop in the future as well as those which now exist. These advisors shoud be given notice that sound reasoning must prevail and those who purchase such schemes will not be rewarded by a grandfathering clause.

Much has been said about the need to encourage savings for investment purposes. The insurance companies have developed products which are designed around the policyholder making the maximum loan each year. I am not an expert on taxation of life insurance companies; however, you may want to be sure that insurance companies are not permitted to establish reserves for those policies which have maximum loans against them. The reserves of life insurance companies should be decreased by the outstanding loans.

It is shocking to hear that an insurance company worth eight billion dollars did not have any federal income tax liability in the year of 1982. (This was testimony given by a company executive before the House Subcommittee on Select Revenue Measures on May 11, 1983). The insurance companies and individual policyholders have benefited by favorable income tax treatment, but it is not proper to design and sell products which shift a tax burden to others or to the overall deficit.

STATEMENT OF

THE ERISA INDUSTRY COMMITTEE

BEFORE THE COMMITTEE ON FINANCE

U.S. SENATE

ON GROUP TERM LIFE INSURANCE

PURCHASED FOR EMPLOYEES

(Sec 224 of S.1992 AND Sec 224 of H.R. 4170)

for Hearings held January 31, 1983

STATEMENT BY THE ERISA INDUSTRY COMMITTEE
ON GROUP TERM LIFE INSURANCE PURCHASED BY THE EMPLOYER
(Sec. 224 of S. 1992; Sec. 224 of H.R. 4170)

INTRODUCTION

The ERISA Industry Committee (ERIC) is pleased to have this opportunity to express its views on legislation affecting the tax treatment of group term life insurance purchased for employees (IRC Sec. 79).

ERIC, an association concerned with employee benefits policy issues, consists of over 100 major companies, all of which maintain substantial pension and welfare benefit plans for their employees. ERIC members represent a wide cross section of major American businesses; the benefit plans of these members are numerous, varied and in all cover millions of participants.

SUMMARY

ERIC opposes those changes in the tax treatment of employer-provided group term life insurance proposed in Section 224 of S. 1992 and Section 224 of H.R. 4170 which would:

- reverse long-established Congressional policy that retirees not be taxed on employer-provided group term life insurance;

- run contrary to the efforts of legislation recently passed by the Senate to improve retirement protection for women;

- have an adverse impact on rank and file workers many of whom have or expect to receive employer-provided group term life insurance protection greater than the $50,000 limit in Section 79;

- fail to address the current out-of-date tax exclusion for employees covered by employer-paid group term life;

- create a new tax on retirees, or alternatively, result in reduced protection available to retirees under group term life insurance plans.

Employer-paid group term life insurance is a valuable component of employee benefits. Unnecessary restrictions on retiree life insurance could have a debilitating effect on employer-paid group term life insurance, one of the most effective, least expensive, and widely used ways of providing protection to retirees and their families. No action should be taken to restrict benefits in this area without great care and consideration of the long range effects on retiree protection.

ERIC members urge that, in keeping with the original purposes of Section 79, no income be imputed to retirees for group term life insurance provided by their employers.

ERIC also notes that a strong "grandfather" provision is necessary, but that certain aspects of the current proposal are unclear.

BACKGROUND

Under Section 79 of the Internal Revenue Code income is not imputed to employees for the first $50,000 of group term life insurance provided by the employer. No income is imputed for all group term life insurance provided by employers where the employee has terminated his employment and has reached normal retirement age or has become disabled.

Section 79 was added to the Internal Revenue Code in the Revenue Act of 1964 (P.L. 88-272). The $50,000 cap has not been changed since that date. Provisions regarding non-discrimination were added in The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248).

Sections 224 of S. 1992 and H.R. 4170 extend to retired employees the present treatment for active employees. That is, the amendment imputes to the retired employee income equal to the cost of employer-provided group term life insurance above $50,000. In discriminatory plans, currently the full value of the insurance (not just that above $50,000) is imputed to key employees. The proposed amendment provides that where the plan is discriminatory, key employees and key employee retirees must include in income the actual cost of the insurance rather than amounts based on the uniform premium table provided by the Secretary of the Treasury.

DISCUSSION

SECTION 224 REVERSES LONG-ESTABLISHED CONGRESSIONAL POLICY THAT RETIREES NOT BE TAXED ON EMPLOYER-PROVIDED GROUP TERM LIFE INSURANCE.

In establishing the policy in this field in 1964, Congress noted that:

> "it would be undesirable to tax the aged or disabled individual who is no longer working for group term life insurance protection provided to him by his former employers." (House Report 88-749, p. 40)

The policy established in 1964 is correct and has worked to provide substantial, necessary, and efficient financial protection for retirees and their families. Life insurance provided to retirees does aid family stability. Retirees generally must live on fixed incomes and face material strains on that income through general increases in health costs and other necessary expenses. Since more and more people are living longer, the protection afforded through group term life insurance coverage is even more important in maintaining an acceptable standard of living for retired families than has been the case in the past. Recognizing this need, many corporate group term plans automatically provide post-retirement insurance coverage.

ERIC strongly urges, therefore, that Congress not reverse its twenty year policy of protection of retirees by extending the Section 79 limits to them.

SECTION 224 RUNS CONTRARY TO THE EFFORTS OF LEGISLATION RECENTLY PASSED BY THE SENATE TO IMPROVE RETIREMENT PROTECTION FOR WOMEN.

Most beneficiaries of employer-provided group germ life insurance are women. Because survivor benefits are often reduced in pension plans and because of the effects of actuarial reductions for early benefits, the material assistance provided through group term life insurance is generally more substantial than that provided through pension plans. It provides a means to offset any loss of income continuation. ERIC strongly believes in, supports, and advocates strong pension programs. But it would be shortsighted and unwise to discourage the complimentary benefits provided through group term life by taxing the coverage of retirees. Both pension and life insurance are needed to provide adequate protection to surviving dependents and both should be encouraged.

EXTENDING THE CURRENT PROVISIONS OF SECTION 79 to RETIREES WILL AFFECT BENEFITS OF RANK AND FILE WORKERS.

While there is a perception that group term life insurance can provide disproportionate benefits to key employees, the fact is many companies offer group life on an across-the-board basis. In correcting perceived or real abuses, ERIC urges that the Congress do nothing which would endanger or diminish the benefits to other employees. Problems associated with the relatively few plans which may benefit key employees disproportionately can be addressed without changing the current status of the large majoity of plan participants.

A large proportion of rank and file employees reaching retirement age will have insurance protection substantial enough to be affected by the $50,000 limit on excludable group term life insurance. This is because average wage levels at retirement generally are substantially higher than the average wages of workers of all ages and because many plans offer coverage based on salary.

Following are examples from three ERIC companies:

Company A: After eliminating from the calculation all retirees from this company with salaries of $100,000 or more at retirement, there were approximately 3900 hourly and salaried workers retiring in 1982 and 1983. The average salary of this group at retirement was about $38,000 and the average age 60. Under the proposed legislation, these retirees would have an average of $40,000 of taxable employer-provided insurance coverage in the usual case in which the retiree had a spouse or dependent beneficiaries. The $40,000 is the coverage provided over and above the $50,000 exclusion in current law and the coverage provided for by the retiree. Further, even though the amount of coverage is stepped down somewhat in the first years of retirment, at age 65 such taxable employer-provided insurance coverage is still $36,000; and a taxable amount still remains at age 80.

Company B: As of December 1983, this company had over 55,000 salaried employee retirees, some newly retired and some who have been retired for many years. Those who have been retired for some time generally have lower coverage than current retirees because their final wages were lower than current levels and because their life insurance coverage is generally reduced on a gradual basis over time. Nevertheless, almost 30 percent of this large group of retirees still has coverage of over $50,000 under the employer-paid group term life plan.

Company C: This company's plan plan provides for life insurance at age 60 of two times pay plus an additional survivor income benefit. The survivor income benefit is based on retirement pay, and the two times pay provision is gradually stepped down between ages 66 and 70. Under this plan, the employee who retires with only a $20,000 final wage at age 60 will have $68,000 in insurance and be over the $50,000 exclusion. At age 65, he will still have $66,000 in insurance. An employee retiring with a salary of $35,000 would, at age 70, still have insurance valued at $58,500 and be subject to the new tax.

Further, the impact of this provision will grow rapidly in the future as general wages increase, so that more and more retirees will be affected by the exclusion limits of Section 79.

SECTION 224 TAKES NO ACTION TO SET A REALISTIC EXCLUSION LEVEL:

The current exclusion of $50,000 of employer-paid group term life insurance was set in 1964. Since 1964 the Consumer Price Index has increased 233 percent; average wages have increased 215 percent in current dollars; the social security wage has increased almost 700 percent (from $4,800 to $37,800). If the $50,000 exemption were updated to reflect changes in the CPI, it would result in a current exemption level of $166,500.

Congress should raise the Section 79 exemption level in the near future -- not extend an out of date level to a new group of individuals.

BECAUSE MANY RETIREES WILL HAVE INSURANCE COVERAGE OVER THE EXCLUDIBLE AMOUNTS, SECTION 224 WILL ADD TO THE FINANCIAL BURDENS OF RETIREES.

While it is true that active employees currently are taxed on the value of employer-provided group term life insurance over the $50,000 exclusion, Congress deemed it inappropriate in 1964 to extend that taxation into retirement. Retirees have incomes which generally are both fixed and reduced. They will be asked to pay equivalent taxes with less income. The long range effect of this additional commitment on sparce retirement resources likely will be pressure to reduce, across-the-board, group germ life insurance protection for retirees.

THE GRANDFATHER PROVISIONS MUST BE CLEAR AND STRONG.

Should an amendment in this area be passed, no current retiree should be affected by any changes made. Since group life insurance is conventionally provided through a group life insurance policy that is renewed annually, any restrictive language regarding renewals and other normal transactions could negate the value of a grandfather clause. (See House Report 98-432, p. 155) Also, it is not clear what would constitute a change in a plan so that the plan would be considered not in existence on the grandfather date. (Joint Committee Print JCS 1-84, p. 29)

ERIC strongly urges that a clear and broad grandfather provision be adopted if any amendment is passed and would be happy to work with staff further in this regard.

CONCLUSION

The provisions of Section 224 which extend the current treatment of employer-paid group term life to retirees will have a seriously adverse effect on one of the most effective and last expensive ways to provide a necessary floor of protection for retired workers and their families.

STATEMENT OF
EXECUTIVE LIFE INSURANCE COMPANY
IN CONNECTION WITH
HEARINGS BEFORE THE SENATE FINANCE COMMITTEE
ON THE
POLICYHOLDER PROVISIONS OF S. 1992

JANUARY 31, 1984

Executive Life Insurance Company, a company based in Beverly Hills, California, offers a range of life insurance products. The company has a number of substantive concerns which it shares with other members of the industry with respect to the policyholder provisions of S. 1992. Executive Life would like to take this opportunity, however, not to repeat or endorse positions already brought before the committee by industry associations, but to request consideration of two technical issues which may create unintended and unnecessary difficulties for companies attempting to comply with the new definition of life insurance set out in section 221 of the bill.

(i) Expense Charges in Guideline Level Premium Computation

In computing the guideline level premium for purposes of new section 7702, reference is made to charges other than mortality charges specified in the contract. This will usually mean the expense amounts which, in the case of traditional products and many "universal life" products, are charged annually. Executive Life, however, offers a product which it calls "Irreplaceable Life", which is now being marketed by a number of other companies, for which no direct expenses except for nominal policy fees are charged during the life of the policy. Instead there is a "rear end" surrender charge which diminishes in amount for each year the policy is held, typically disappearing after 20 years. The company is obviously incurring expenses at roughly the usual rate for these products. It amortizes these expenses over the period of the surrender charge by margins between its experience investment income and mortality rates over its declared rates. In the event of surrender prior to amortization of the expenses, the company is protected by the surrender charge.

Because the stated annual expense amount for such contracts is zero or a nominal amount, the test premium will be reduced, creating a competitive disadvantage. These products, however, offer a substantial advantage to individuals who hold life insurance policies for the long term. With traditional products, an individual who surrenders a policy after only a few years will have paid less than the full amount of expenses attributable to his policy, while an individual who holds a policy for 20 years in effect pays a share of this difference. With the new Irreplaceable Life products, an attempt has been made to eliminate the disproportionate charge to those who hold policies throughout the surrender term, and thus to encourage a long term view of life insurance planning.

To eliminate the disincentive for these new products created by the guideline level premium definition, the company proposes that an assumed or imputed expense charge be allowed when no explicit charges (other than nominal fee amounts) are specified. Specifically, when no explicit expense charges are set for a whole life contract with level premiums payable to at least age 95, the guideline level premium calculation should include an imputed expense charge equal to 50 percent of the level annual premium in the first year and 10 percent of the level annual premium thereafter. This is significantly below actual expenses, and thus is not calculated to open up avenues of abuse. It should serve, however, to lessen the discrimination in treatment among products, and to eliminate the disincentive to an attractive new policy form.

(ii) Cash Value Test: Actuarial Problems

The cash value accumulation test of the new section 7702 requires that the cash surrender value of the contract may not "at any time" exceed the net single premium which would have to be paid at such time to fund future benefits under the contract. This requirement is inconsistent with actuarial functions and traditions, since life insurance contracts have traditionally been drafted and administered on a policy year basis. Changes in the benefit structure occur at the end of policy years and cash values are computed at the end of policy years, on the artificial assumption that deaths occur at the end of policy years. Using traditional techniques, the cash value at the beginning of the policy year would be applied to purchase the benefits of the contract by a net single premium based on the assumption that deaths occur only at the end of successive policy years.

Actually, of course, deaths occur when they will, and cash values during the policy year are interpolated between the two policy-year-end cash values. Consequently, traditional actuarial techniques would result in compliance with the "at any time" requirement only at the very beginning of a policy year. For the balance of the year a contract would not technically comply if the interpolated cash value were greater than the cash value at the beginning of the year.

The cash value test can be made to reflect traditional actuarial techniques by changing the reference to "at any time" to "at the beginning of each policy year", for products providing for policy year adjustments. This change would simplify the efforts of the insurance industry to comply with the revisions of the law, and should raise no problems of policy, with two caveats. First, in such a case the death benefit during the year must be level. Second, in the case of "flexible premium policies" as defined by TEFRA, there is the possibility of significant increases in cash value during the year simply by payment of substantial premiums at the election of the policy holder. In such policies, the "at any time" requirement can be retained. "Universal Life" products tend to be administered on a monthly basis, and can therefore probably comply with the test as presently drawn.

Both of these matters involve technical rather than substantive policy problems. They may not be among the major issues to be advanced in final consideration of the bill, but each is significant in its way, and each can be addressed without compromising the intent of the legislation.

Transition

Executive Life would also like to bring to the committee's attention an issue involving the transition rules for sales of policies during 1984. S.1992 would allow 1984 sales of policies which do not meet the life insurance definition rules of new section 7702, but which would qualify as life insurance under the specific tests developed for flexible premium products by TEFRA. There is no reference to, and apparently no provision for, policies which are not flexible premium products, but which would have qualified as life insurance under the non-statutory definition reflected in case law and Internal Revenue Service rulings prior to the end of 1983.

There does not seem to be any compelling reason to distinguish, for transition purposes, between flexible premium products and other forms of life insurance, provided that the products would have been treated as life insurance if sold prior to December 31, 1983. The process of qualifying policies to be sold in the states is an extremely cumbersome, time-consuming, and costly one. If a company has gone through such a process in order to have its policies approved for sale prior to December 31, 1983, and if such policies prior to that date qualified as life insurance under the law in its then form, Executive Life believes that the policies should be treated as life insurance and allowed to be offered for sale through the end of 1984.

An extension of the 1984 transition rule to policies other than flexible premium policies will give due recognition to the efforts made and costs incurred by certain companies prior to the end of 1983 in developing products designed to meet certain insurance needs. At the same time, an application of the transition rule by reference to the definition of life insurance as in effect prior to December 31, 1983, should prevent reliance on the transition provision to support sales of what the Treasury regards as "abusive" products.

Julie Noel Gilbert
Cohen and Uretz

STATEMENT OF WILLIAM G. POORTVLIET
Senior Vice-President and Chief Actuary
Metropolitan Life Insurance Company
on Section 224 of S.1992

Metropolitan Life Insurance Company appreciates this opportunity to submit our views on the Life Insurance Company Tax Act of 1983 to the Committee on Finance.

Metropolitan Life is a mutual life insurance company incorporated in the State of New York in 1868. For the reasons set forth herein, Metropolitan opposes Section 224 of S.1992 which would impose a new and burdensome tax upon retirees who are provided group life insurance by their employers.

A review of the legislative history of group life insurance taxation indicates that in 1964 the Congress generally sought to encourage employers to provide group term life insurance coverage for their employees.

Indeed, the Senate Finance Committee, in its Report on the Revenue Act of 1964, stated:

> "The House, despite recognizing that the entire cost of this insurance protection represents compensation to the employee, provided an exemption with respect to the premiums paid on the first $30,000 of such insurance because it believed, from the standpoint of the economy as a whole, that it is desirable to encourage employers to provide life insurance protection for their employees. Provision of such a basic amount of insurance does much to keep together family units where the principal breadwinner dies prematurely. Your committee is in accord

> with the reasoning of the House on this subject but believes that $70,000 represents a more appropriate exemption level." (Emphasis added)

As to the tax treatment to be afforded retired employees, the Senate Report language is equally clear.

> "Both the House and your committee's bill provides an exception to the general rule described above where the individual's employment has been terminated and either he has reached the normal retirement age (under the practice followed by his employer) or he has become disabled. In both of these cases it was concluded that it would be undesirable to tax the aged or disabled individual who is no longer working for group term life insurance protection provided to him by his former employer." (Emphasis added)

The final version of the bill represented a compromise between the House and Senate positions with respect to active employees. Specifically, active employees were permitted $50,000 of tax-free life insurance. Both Houses agreed, however, that it was socially desirable to provide completely tax-free protection for retired employees. Thus, both the House and the Senate recognized a key phenomenon which differentiates a disabled or retired employee's life insurance benefit from a disabled or retired employee's pension benefit: The retiree, by definition of the life insurance benefit itself, receives no current income from which he could pay the tax.

What has happened since 1964? For one thing, the Consumer Price Index has increased 233% which indicates that the economic value of the $50,000 exemption has been seriously eroded. As an example, a death benefit involving proceeds of $50,000 might now enable a widow aged 65 to obtain an annual annuity income of perhaps $5,500 which is less than 60% of the current national poverty level. In our opinion, this suggests that the $50,000 exemption for active employees should be updated to reflect the CPI increase. This would result in an exemption level of $166,500 if the $50,000 figure were updated or a $233,000 exemption level if the original Senate-proposed $70,000 exemption were updated. However, the legislation now being considered, instead of updating the 20-year-old $50,000 exemption, would go in the opposite direction and would introduce taxation on retirees where none had previously existed. This new burden - imposed upon individuals with fixed incomes and with no plans to absorb such a burden - appears to us to be unwise and unfair, particularly when coupled with recent changes which will tax the Social Security income of an increasing number of retirees.

Does Congress now believe that encouraging employers to provide financial protection to their employees and retirees is no longer the sound policy that it was 20 years ago? We do not think so. On the contrary, in the pension area we notice that the Administration and many members of Congress are responding to women's rights groups by supporting legislation which would substantially expand entitlement to survivor's benefits. Why then would Congress wish to discourage benefits for the survivors under group life insurance plans?

Of course, in the final analysis it is for this Congress to decide whether or not the intentions of a prior Congress should be reinforced or reversed. But it is equally important that we provide this Congress with our best advice as to the outcome if retirees were taxed according to the legislation now being considered. The outcome as we see it would be a substantial curtailment of insurance coverage provided by employers for their retired employees because workers, who generally experience a decrease in income upon retirement, will be unwilling to absorb an increase in their tax payments.

Furthermore, the potential taxation and the resulting curtailment of insurance coverage would, before long, extend to virtually all retirees. This would happen because insurance provided by employers is generally tied to salaries and salaries are likely to increase. For example, an employee now earning $15,000 with life insurance equal to twice his or her pay now has $30,000 of protection. However, with salary growth of 6% per year, the protection would reach the taxable level of $50,000 in only 9 years. Accordingly, the most likely scenario is that virtually all retirees would be taxed in the not-too-distant future. Since, in our opinion, employers will be unwilling to continue programs which will cause their retirees to be taxed, it is likely they will substantially curtail this valuable coverage - perhaps not today or tomorrow - but certainly as more and more of their retirees become subject to taxation on amounts above $50,000.

In accordance with the foregoing, our overriding concern is that the legislation under consideration would be detrimental to the financial security of our Nation's retirees. Moreover, we believe there are several other important points:

1) We believe that taxation of retirees will - in practice - produce little, if any, increase in tax revenue from retirees whether or not there is a "grandfather provision." In the short run, an effective "grandfather provision" would mean little or no tax revenue. In the long run, a new tax is likely to seriously curtail this form of retiree protection and thus generate little or no tax revenue.

2) In many situations, retiree benefit programs involve employers setting aside sums of money to be accumulated over long periods of time on behalf of future retirees. Funds so accumulated may be expected to have a salutary impact upon both the needs of the Nation's aged population as well as the needs of the Nation for long-term investment capital. If retiree taxation leads to curtailment of this protection, it will also diminish such fund accumulations.

3) The proposed tax is on people, retired people. As such, it should be considered separately from legislation which essentially taxes insurance companies. Even when considered in the general context of fringe benefits, it is our conclusion that the needs of the Nation's retirees are so special as to warrant special and separate consideration.

For these reasons, we urge the Congress to eliminate the provisions of the Life Insurance Company Tax Act which would impose a new tax upon the retirees of our Nation.

United States Senate Committee on Finance
Hearings on Tax Treatment of Life Insurance Products
and Policy Holders
January 31, 1984

Written Statement of
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The Midwest Life Insurance Company is a relatively small firm (assets of $53 million at year end 1983) offering insurance products through broker dealers and independent agents. It is licensed to do business in twenty-eight (28) states.

S1992 would alter the Internal Revenue Code's application to insurance companies, their products and policy holders in several respects. This statement is limited to the elements of the bill which would have the greatest impact on the Company, its products and customers, and to a proposal that the bill be expanded to amend Code section 801(g) to eliminate double taxation of capital gains under nonqualified variable annuity contracts.

A. Section 222:

1. Penalty Tax on Early Withdrawal.

Section 222 (a) of the bill would eliminate the ten year holding period exemption from a penalty tax on withdrawals from nonqualified annuity contracts. The penalty tax, as well as the holding period exemption, were part of the changes to the code adopted as "permanent" measures in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The insurance industry, the Treasury Department and, it was thought, Congress, had concluded that this feature of TEFRA was a fair resolution of a perceived abuse of annuities as short term investments, while retaining their attractiveness as savings and long term capital appreciation vehicles.

The proposed elimination of the holding period exemption is a shocking retreat from a thoughtful compromise. If adopted, it will unfairly disadvantage nonqualified annuity contracts as retirement savings vehicles. Annuity contracts have historically been and continue to be a source of retirement income for individuals. The ability to withdraw from these savings to meet emergency and other unexpected expenses was substantially restricted by TEFRA. The proposal would further restrict the use of annuity savings and thus make annuity contracts relatively unattractive. This sort of negative incentive for savings is neither desirable nor wise.

Moreover, the proposal will not generate a measureable increase in tax revenues and does not appear to be addressed to any perceived abuse. It is thus unnecessary. The wisdom of the proposal is not apparent. It is a disappointing retreat from a fair compromise. It will produce unfair results. We submit that Section 222 (a) should be deleted from the bill.

2. Taxation of Annuity Where Holder Dies Prior to Starting Date:

Section 222 (b) of the bill would include as income of a decedent the cash surrender value of a nonqualified annuity contract where the "holder" dies before the annuity starting date. This proposal presents both technical and substantive problems.

The use of the term "holder" is confusing. Changing the term to "owner" is not helpful because of the existence of non-individual owners which, of course, could not die in the sense of the proposal. Use of the term "annuitant" would not resolve the confusion, either, because of contingent and joint ownership.

The proposal presents a much more difficult and substantive problem - one of fairness. This provision would tax the estate of the decedent without regard to the receipt of income. Unless the beneficiary of the contract is the decedent's estate, the tax will not be imposed on the receipient of the taxable gain. This result is unfair. To impose a tax on the estate, irrespective of the receipt of income, will discourage the use of annuity contracts as savings vehicles and unfairly punish non-beneficiary heirs.

Even in instances where the beneficiary is the estate, the proposal can produce unfair results. The tax is imposed on the entire gain. This would tend to force an election of lump sum distribution and effectively render inoperable the option, available under section 72(h) of the Code, to select an annuity payout. The forcing of lump sum distribution is undesireable. It would tend to frustrate the use of spend thrift provisions by taxing the entire gain.

We are aware of no projections which suggest that this unfair taxation will produce appreciable revenue for treasury. We submit that it is unfair, unwise because it would discourage savings, and unneccessary, and thus urge that it be deleted from the bill.

3. General Discussion of the Fairness of Section 222:

Sections 222(a) and (b) of the bill are distressingly punitive measures which will unfairly tax the owners and beneficiaries of annuity contracts. The fact that they are proposed in the wake of the "permanent" measures adopted in TEFRA is also disturbing. Congress, it was generally thought, had leveled the competitive playing field for non-qualified tax deferred investment and savings vehicles in adopting TEFRA. The industry prepared and distributed materials advising its clients of the new rules. Now, in the absence of any perceived abuse, without hope of raising tax revenues and in contradiction of wisdom, sections 222(a) and (b) would discourage the use of non-qualified annuity contracts as a savings vehicle. There is not a good reason to adopt sections 222(a) and (b). We urge that they be deleted.

B. Taxation of Gain in Annuity Value at the Company Level.

Section 801 (g) (7) of the Internal Revenue Code discriminates between qualified and nonqualified annuity contract capital gains in the imposition of tax at the company level - nonqualified contract capital gains are taxable while those under qualified contracts are not. This results in double taxation of gains under nonqualified contracts - once at the company level and, again, at higher ordinary income rates in the hands of the recipient. This unfair result was apparently accepted as part of the compromise leading to the adoption of Section 801(g) in 1959. TEFRA's imposition of a penalty on early withdrawals from annuities eliminated the basis for the compromise and made annuity contracts less attractive savings and investment vehicles.

The company submits that the double taxation of these gains is unfair and that the tax at the company level should be eliminated.

C. Small Life Insurance Company Deduction.

The Life Insurance Company tax provisions of S1992 would create a "Small Life Insurance Company" deduction. The deduction would be made available (according to the Committee Report on the identical House version of the provisions, HR4170), in order to enhance the availability of capital to small companies during their growth period. As proposed, however, the deduction would be denied to otherwise qualified small companies if they are affiliated with larger firms. The denial of the deduction is predicated, the Committee Report suggests, on the theory that any affiliation with a large firm, as measured by its gross assets, will provide a source of needed capital for the small insurer during its growth period.

We believe that the gross asset test used to define qualification for the deduction is not an accurate measure of the availability of capital to a small insurance company. We suggest that consistency with the stated purpose of the deduction requires that the net assets (gross assets less debt to outside parties other than policy holders) of the claiming insurance company and its affiliates be used as the test for qualification. This approach will grant the deduction on the basis of capital availability, and not affiliation, and fairly distribute the competitive advantage the deduction represents.

February 16, 1984

MUTUAL COMPANY STATEMENT
ON
S. 1992

Hearings Before The
United States Senate
Committee on Finance

January 31, 1984

The following statement is submitted on behalf of the Mutual Company Executive Committee and summarizes the views of mutual life insurance companies on the provisions of S. 1992, the Life Insurance Tax Act of 1983, that affect directly the tax treatment of life insurance products and policyholders. The Mutual Company Executive Committee, which is comprised of 12 companies, was formed to provide an information clearinghouse and to formulate positions on life insurance company tax legislation on behalf of all mutual life insurance companies. Appendix A lists the companies on the Committee.

Mutual companies strongly urge the Committee to act promptly to approve the provisions of S. 1992 with one substantive amendment that would correct the discriminatory treatment of variable contracts under the bill. The reasons supporting prompt action on S. 1992 with a variable contract amendment, and mutual company views on other policyholder issues are summarized in the remainder of this statement.

A. Prompt Enactment of S. 1992 Is Needed.

Temporary stopgap rules governing the income tax treatment of life insurance companies and their policyholders expired December 31, 1983. The 1959 Act, which, in the absence of further legislation, would apply January 1, 1984, produces serious inequities and distortions in the taxation of life insurance companies and their products. It is thus generally recognized that the 1959 Act must be replaced and that new permanent rules to cure its deficiencies are needed effective as of January 1, 1984. S. 1992 would provide those rules.

The prompt enactment of S. 1992 will also provide needed certainty with respect to the tax treatment of life insurance companies and their products. As pointed out in the January 23, 1984, edition of Business Week (p. 113), life insurance companies are delaying pricing decisions on their products pending action on this tax legislation. Further, until new legislation is enacted, the tax status of some life insurance products is unclear. Uncertainty with respect to the tax treatment of life insurance companies and their products hurts new sales of life insurance products, which in turn, harms the nation's economy. The life insurance industry provides 800,000 jobs; it contributes $65 billion annually to the country's long-term capital base; and it helps provide financial security for over 160 million Americans.

S. 1992 has broad based support. A majority of the Senate Finance Committee has cosponsored the bill. The House Ways and Means Committee has unanimously approved substantially similar provisions as part of H.R. 4170. The bill is also supported by all segments of the industry -- stock companies, mutual companies and agents' organizations.

B. Why Mutual Companies Support S. 1992.

S. 1992 would replace the current tax system, the 1959 Act, with a more equitable tax law. The bill's structure is closer to that applicable to all other corporations and does not contain the many artificial provisions of the 1959 Act. In contrast to the 1959 Act, the bill provides for a single phase tax system. The bill would also have the beneficial effect of limiting life insurance tax treatment to those contracts whose primary purpose is to provide life insurance protection.

S. 1992 embodies extremely complex issues, difficult tax policy decisions and tough compromises. In this context, and with an amendment to eliminate the discriminatory treatment of variable contracts and some other more technical refinements, mutual companies strongly support the early enactment of this critical legislation.

The revenue level that would be imposed on the life insurance industry under S. 1992 (estimated at $2.9 billion in 1984) is also sufficient. This view is supported by the following facts.

- The tax imposed under the bill would represent a substantial tax increase as compared to taxes actually paid in the past and estimates of tax liabilities for 1982 and 1983.
- Under the bill, it is estimated that for 1984 life insurance companies would pay about 5 percent of total corporate taxes, while life insurance companies would account for only about 3.7 percent of corporate equity, 3.3 percent of corporate gross receipts and one percent of corporate-sector GNP.
- Under the bill, life insurance companies would pay a higher effective tax rate than corporations generally.
- The tax rules of the bill are more restrictive overall than the tax rules applicable to corporations generally and thus will raise more than a fair share of corporate tax revenues.

C. Variable Contracts

S. 1992 would deny life insurance companies a reserve deduction for amounts attributable to capital appreciation that are credited to the reserves held for policyholders of variable life insurance or annuity contracts. Capital appreciation credited to reserves for fixed benefit contracts or so-called universal life policies is fully deductible under the bill. S. 1992 should be amended to remove this discriminatory tax treatment of variable life insurance and annuity contracts.

Variable life insurance is an important relatively new form of life insurance. It is designed to give consumers the power to keep their life insurance policies in step with changing economic conditions within the concept of traditional life insurance. Specifically, the death benefit under a variable life insurance policy automatically increases if the investment performance of the assets supporting the policy exceeds the interest rate used in setting the guaranteed death benefit. This occurs because the favorable investment results are applied to provide additional amounts of life insurance. The policy, and any increased amount of life insurance protection, must meet the new definition of "life insurance" in S.1992 at all stages of the policy. Thus, variable life insurance adapts traditional life insurance protection to current investment return and thus provides a valuable hedge against inflation.

1. S. 1992 unfairly disciminates against variable contracts.

For all other types of insurance contracts, companies are allowed a full deduction for amounts credited to policyholder reserves whether the source of the amount credited is capital gain income or ordinary income. For example, if an insurance company realizes capital gain income of $100 which it credits to reserves for whole life policyholders or universal life policyholders, the company is allowed a deduction for an increase in reserves of $100. The deduction offsets the capital gain income so that no taxable income results to the company from the transaction. In the case of variable contracts, under the provisions of S. 1992, the company is denied the reserve deduction, but is required to include the capital gain in the income even though it credits the entire $100 to reserves for its policyholders.

The tax laws should permit, on a neutral basis, whatever investments provide the best return and security for policyholders. Thus, amounts set aside to pay benefits or increase reserves for policyholders should be deductible regardless of whether the source of such amounts is ordinary income or capital gains.

It has been suggested that the variable contract provisions of S. 1992 are defensible on the grounds that, without the tax penalty imposed under those provisions, investments in equities on a tax-deferred basis will be permitted that compete directly with taxable forms of such investments, such as mutual funds. This is simply not true. The definitional requirements of the bill will assure that the purpose of a variable life insurance contract is to provide life insurance protection. The contract involves mortality and other charges that are not relevant to investment arrangements. The restrictions imposed by TEFRA on early withdrawals from annuity contracts also assure that variable annuity contracts cannot compete with currently taxable investments in mutual funds.

2. S. 1992 will make variable life insurance noncompetitive.

The additional tax burden that the provisions of S. 1992 would impose on variable life insurance would directly reduce both the death benefits and cash values provided under the policies, thereby making the contracts noncompetitive with other life insurance policies. Variable life insurance contracts serve the same purposes and must satisfy the same definitional requirements as fixed benefit whole life insurance and universal life insurance. Accordingly, it is unfair to provide more onerous tax treatment for variable life insurance than is provided for such other forms of insurance.

The anti-competitive implications for variable life insurance are borne out by the experience of variable annuity contracts, which are subject to similar discriminatory tax treatment under existing law. Life insurance companies have been required either to abandon their products, or severely restrict the investments available, because of the impact of the tax burden. This tax treatment should be corrected, and it clearly should not be extended to variable life insurance.

3. The proposed compromise with respect to variable contracts is unsatisfactory.

A compromise amendment to S. 1992 has been suggested to deal with variable contracts. Under the compromise, the tax paid by insurers on capital gains attributable to variable contracts would be imposed at the maximum individual rate of 20 percent, instead of the corporate rate of 28 percent, and would increase the policyholder's basis in his contract. This approach is unsatisfactory for several reasons.

First, the compromise would go only part way toward achieving parity of tax treatment between variable contracts and other insurance contracts. Any degree of tax discrimination against variable contracts is unfair and will seriously disadvantage the product in the marketplace.

Second, in the case of variable life insurance contracts, any benefit from the proposed basis adjustment could only be received if the policy were surrendered. Thus, it would have no effect in even partially removing the discriminatory tax burden for the policholder who retains his policy for the purpose for which he purchased it.

Finally, the proposed basis adjustment would cause serious administrative and reporting problems.

For the above reasons, we urge that S.1992 be amended to provide tax equality for variable contracts. This can be simply done by expanding proposed I.R.C. § 817(d)(2) to cover all variable contracts.

We are pleased that the Treasury Department in its oral testimony to the Senate Finance Committee on January 31, 1984, acknowledged that variable life insurance should be treated like other forms of life insurance and not taxed at the company level on capital appreciation added to policyholder reserves. However, we strongly disagree with the suggestion at page 9 of the Treasury Department written statement that indicates a belief that it would be appropriate to impose a capital gains tax when a variable policyholder switches his funds from one investment option to another within a policy. Such a change in treatment would unjustifiably single out variable life insurance for a special tax not imposed on competing forms of permanent life insurance.

In fixed benefits policies, policyholders are not taxed unless they surrender policies, and this is true regardless of how the insurance company invests the assets funding these contracts. The only difference between fixed and variable policies is that consumers are given some limited say in how the funds supporting their insurance benefits are invested, and thus are given an opportunity to participate in maximizing their insurance coverage. However, under the Treasury suggestion, if consumers exercise their limited right concerning the broad investment strategies for investing the funds underlying their policies, there would be a tax even though they have not surrendered their policies or otherwise realized any current cash benefits. Discrimination against variable life insurance is exactly what the variable contracts amendment is intended to correct.

D. Policyholder Provisions

1. Definition of Life Insurance.

Mutual companies support the provisions of S. 1992 concerning the definition of life insurance. While some technical clarifications may be needed, the new definition of life insurance (1) would add to the Code objective guidelines to determine if a contract qualifies as a life insurance contract, (2) would assure that the tax treatment accorded life insurance contracts is limited to contracts which provide a reasonable amount of pure life insurance protection at all times, and (3) should discourage the sale of products which are overly investment-oriented.

2. Other Policyholder Provisions.

S. 1992 would amend present law to (1) limit further the deduction of interest on policyholder loans to an amount determined by multiplying $250,000 ($500,000 in the case of a joint return) by the deficiency rate prescribed under section 6621; (2) extend the 5 percent penalty on premature distributions from annuity contracts to any amount distributed to the taxpayer before the age of 59 1/2 without regard to whether the distribution is allocable to an investment made within 10 years, and trigger the income in an annuity contract in the event of the death of the owner before the annuity starting date; and (3) extend the rules applicable to group-term life insurance purchased for active employees to such insurance purchased for retired employees. As part of the mutual company position of overall support for the bill, mutual companies do not oppose these provisions.

APPENDIX A

MUTUAL COMPANY EXECUTIVE COMMITTEE

Empire State Mutual Life Insurance Company

Guarantee Mutual Life Company

The Guardian Life Insurance Company of America

John Hancock Mutual Life Insurance Company

Massachusetts Mutual Life Insurance Company

The Mutual Benefit Life Insurance Company

National Life Insurance Company

New England Mutual Life Insurance Company

The Northwestern Mutual Life Insurance Company

Provident Mutual Life Insurance Company of Philadelphia

The Prudential Insurance Company of America

Security Benefit Life Insurance Company

JOINT STATEMENT OF
THE LIFE INSURERS CONFERENCE
AND
THE NATIONAL ASSOCIATION OF LIFE COMPANIES
REGARDING ~~THE~~
TAX TREATMENT OF LIFE INSURANCE PRODUCTS
AND POLICYHOLDERS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

January 30, 1984

Mr. Chairman and distinguished members of the Committee, this statement is submitted jointly by the Life Insurers Conference ("LIC") and the National Association of Life Companies ("NALC"). We appreciate the opportunity to submit this statement to the Committee to express the views of the LIC and the NALC on the tax treatment of life insurance products and policyholders as proposed in S. 1992.

The Life Insurers Conference is an association of small- and medium-sized life insurance companies which primarily offer traditional life insurance to lower and middle income families through the home service marketing system. The LIC, which has its headquarters in Richmond, Virginia, currently has 80 member companies located in 21 States, the District of Columbia, Puerto Rico and the Bahamas.

The NALC, which is headquartered in Atlanta, Georgia, has 450 member companies domiciled in 43 states. NALC companies are predominantly small- and medium-sized stockholder-owned life insurance companies. These companies have more than 200,000 home office and field employees who provide insurance products to millions of policyholders throughout the Nation.

In announcing these hearings, Mr. Chairman, you requested that testimony focus on the proper tax treatment that best serves the "legitimate insurance needs" of policyholders. We have broadened the focus of our testimony somewhat to analyze the impact of these provisions on our member companies. However, before expressing our limited concerns with respect to the policyholder provisions of S. 1992, we would like to commend Senators Bentsen and Chafee for their sponsorship of S. 1992. We support the proposal, concluding that it provides a fair and equitable statutory framework for the taxation of life insurance companies and life insurance products. Moreover, we believe that the $2.9 billion revenue level proposed under S. 1992 is appropriate for the life insurance industry. */

Our membership is concerned, however, over the failure of S. 1992 to address the anomalous situation under current law regarding the double-taxation of capital gains on variable insurance products. We strongly support proposals described by other witnesses at these hearings to eliminate the discriminatory treatment of capital gains at the company level for variable products. Our member companies are also concerned with one aspect of the definition of life insurance, as currently proposed, which would in effect preclude the sale of the traditional endowment contract after 1983. Before focusing on this issue at length, however, we wish to offer our general observations on one other troubling policyholder provision.

While both the LIC and NALC generally support the broad conceptual approach to a definition of life insurance as contained in S. 1992 (excepting the treatment of endowment

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*/ We expect to file with the Committee, at an appropriate future time, comments reflecting our concerns with two corporate tax provisions of S. 1992.

contracts), the Committee should be made aware of the particular sensitivity of small life insurance companies to the abrupt imposition of a new life insurance definition in 1984. Absent liberal transitional rules, application of the new life insurance definition will require discontinuing the sale of well-established traditional life insurance products by many smaller companies. This will have a severe, adverse affect on those companies which are unable to quickly redesign and sell "qualifying" life insurance products, leading to situations where small companies may be forced out of business for lack of a marketable life insurance product. This is clearly inequitable. We feel strongly that the effective date must be delayed until one year after the date of enactment to avoid the harsh impact of a new life insurance definition on companies unable to "retool" immediately their traditional products to meet the new definition.

Impact of Proposed Definition on Endowment Contracts

Both the LIC and the NALC strongly object to the definition of life insurance, as currently proposed in section 221 of S. 1992, insofar as it effectively precludes the marketing of the traditional, long-term endowment contract after 1983 by requiring, in proposed section 7702(e)(1)(B) of the Internal Revenue Code, that life insurance contracts endow no earlier than age 95. The endowment contract is a policy of life insurance under which the proceeds are payable to the policyholder on a maturity date stated in the policy, if the insured is then living, or to the designated beneficiary if the insured dies before that maturity date.

The kind of endowment contract marketed by our member companies is a traditional life insurance product which serves a distinct social purpose for many lower and middle income American families. Moreover, these contracts, because of their inherent life insurance protection, have traditionally been treated as life insurance for tax purposes. We believe they should continue to be accorded such treatment. Although endowment contracts may be regarded as a "cash heavy" investment for the higher bracket taxpayer, the product, in fact, is purchased primarily by lower and middle income taxpayers, the principal customers of our member companies. The LIC and the NALC therefore strongly support amending proposed section 7702 to permit life insurance contracts to endow before age 95. In recognition of the arguable investment orientation of shorter-term endowments, however, we would be content with adoption of a rule which would grant life insurance tax treatment to endowments maturing before age 95, provided that the period to endowment is at least 20 years.

The continued viability of the endowment policy is important for a number of middle and lower income taxpayers who utilize the product as their principal means of obtaining life insurance and supplemental retirement income in one package. This product does not violate the tenets which served as a basis for the proposed definition of life insurance. Particularly, we do not feel that the traditional endowment is an investment oriented life insurance product. Moreover, we believe that the existing tax treatment of endowment contracts, with a transitory exemption for death proceeds that ends with the maturity of the contract, is totally acceptable from a tax policy standpoint in lieu of the permanent exemption of death proceeds in the case of a contract endowing at age 95 or later.

Although traditionally labeled as a "savings" vehicle with the concomitant "heavy" cash value, the endowment product in fact serves several financial and social functions. Professors Huebner and Black, in their oft-cited treatise on life insurance, well described the functions served by endowment policies in these terms:

> Endowment insurance, if the term is so selected to make the policy mature at an age like 60, 65, or 70, may serve as an excellent method of accumulating a fund for support in old age. Many who oppose endowments maturing at earlier periods because of their greater cost are ardent supporters of long-term endowments maturing at an age when an individual's earning capacity usually ceases and when he or she naturally expects to retire from actual work. Relatively few individuals succeed in laying up a decent competence by the time this age is reached. Most people are therefore confronted with two contingencies: (1) an untimely death may leave their families unprotected and (2) in case of survival until old age, they may lack the means of proper support. Both these contingencies may be conveniently provided for by a long-term endowment. If death should occur at any

> time during the term, the insurance proceeds revert to the family, but should the insured survive to old age, when the need for insurance for family protection in the usual sense has largely or altogether passed, he or she will receive the proceeds of the fund that prudence and foresight enabled him or her to accumulate, to be used for his or her own support and comfort, through either the ordinary channels of investment or the exercise of the available options in the policy. */

The hybrid nature of the endowment contract is unique in that it provides life insurance coverage while at the same time serving as a stimulus to encourage savings for lower and middle income families. The function of endowment insurance is not to yield an investment return larger than that obtained from other investments of comparable safety, but rather to afford a method of providing against old age as a supplement to social security payments, in addition to life insurance coverage. **/ The endowment's unique nature precludes a ready comparison of the product with other forms of life insurance.

In light of the fact that the endowment contract functions in part as a savings vehicle, one could conclude that the product would be of particular interest to policyholders in all income brackets. However, this has not been the marketing experience of the membership of the LIC and NALC. Sales of such

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*/ S. Huebner and K. Black, Jr., *Life Insurance* 97-98 (10th ed. 1982).

**/ *Id*. at 96.

policies by our members have traditionally been concentrated in the lower and middle income brackets, because such policies lack the investment attractiveness sought by higher income taxpayers. For example, the face amount of the average endowment policy in 1981 was less than $5,800, indicating that the traditional endowment product was not being marketed to the higher income taxpayer. */

The lack of investment attractiveness could also explain the recent decline in the popularity of the endowment contract industry-wide. In 1981, ordinary endowment policy purchases represented only 1 percent of the total ordinary life insurance purchases in the United States and less than 0.5 percent of the total face amount of such purchases. This compares with 1971, when endowment contracts comprised 6 percent of total ordinary life insurance sales, representing 3 percent of the total face amount of ordinary life insurance sold in that year. Moreover, in 1981, endowment insurance represented only 2.6 percent of the total ordinary life insurance in force, as compared with 4.1 percent in 1977.

Despite all of this, we would emphasize to the members of this Committee that the endowment contract continues to represent a substantial portion of the new and existing business for members of the LIC and NALC. We recognize, of course, that

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*/ All figures are derived from the 1983 Life Insurance Fact Book, published by the American Council of Life Insurance.

the endowment policy is somewhat more oriented toward saving than is the whole life policy that section 7702, in its proposed form, would allow to be written. As Professors Huebner and Black explained in the excerpt we quoted from their treatise, the saving orientation is undeniably a major facet of the endowment policy. But the adoption of a less stringent maturity date restriction, along the lines that we propose, would still deny favorable tax treatment to the short-term, more heavily investment oriented forms of endowment policies. However, it would continue the present law treatment for the long-term contract.

We also think it noteworthy that incorporation of our rule would not short-change the Federal Treasury. Quite the contrary, as under existing law, the proceeds of the contract upon its maturity would be fully taxable to the owner, at ordinary rates, to the extent they exceed the premiums paid. The exclusion of the proceeds is, thus, transitory in the case of a lifetime endowment policy. Should this Committee decide to preserve the present law treatment for long-term endowments, then, the decision would simply be one to continue the "tradeoff" that now exists: providing a transitory death benefit exclusion in the case of a lifetime endowment policy, offset against the inclusion of the maturity value of the contract in the ordinary income of the owner, to the extent it exceeds the amount of premiums paid. For many years this "tradeoff" has been considered fair and viable from all standpoints.

Therefore, the LIC and the NALC specifically propose that section 7702 be modified to permit the use of the latest maturity date permitted under a contract, though in no event a date earlier than 20 years after the date of issue (or, if earlier, age 95). This proposal is identical with the rule provided for under recently expired section 101(f) of the Code. That provision was framed by this Committee in TEFRA with reference only to universal life insurance, but, in that respect, to differentiate the long-term endowment from the short-term, investment oriented contract.

To allay any fears regarding the marketing of endowment policies, we would also support a specific dollar limitation on the amount of endowment coverage that any taxpayer could possess. We submit that a $25,000 face amount limitation would be reasonable, in light of our members' marketing experience, to distinguish the traditional endowment product from the investment oriented product. Any of our suggested changes with respect to the endowment contract could be made through modification of the computational rule described under proposed section 7702(e)(1)(B).

In summary, we wish to reemphasize the importance of the traditional endowment product, not only to the middle and lower income policyholder, but also to the membership of the LIC and NALC, which heavily market the endowment product. We hope that these comments have helped to clarify that the endowment product generally being sold by our member companies is not "abusive" or investment oriented. In short, the traditional endowment contract does not violate the tenets underlying proposed section 7702. We would support any reasonable statutory change that would permit the continued sale of this type of product.

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We appreciate the opportunity to file this statement on behalf of the LIC, the NALC, and the hundreds of smaller life insurance companies which these two trade associations represent. We hope these comments will prove useful in drafting a fair and equitable law with respect to the tax treatment of all life insurance products and policyholders.

NATIONAL FARMERS UNION

STATEMENT OF

ROBERT J. MULLINS
DIRECTOR
LEGISLATIVE SERVICES
NATIONAL FARMERS UNION

SUBMITTED TO THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

CONCERNING

S.1992
"LIFE INSURANCE TAX
ACT OF 1983"

January 31, 1984

Mr. Chairman and Members of the Finance Committee:

I am Robert J. Mullins, Director of Legislative Services for the National Farmers Union. On behalf of the farmer-rancher members of the National Farmers Union and the policyholders of National Farmers Union Insurances, I am submitting to the Committee today this statement outlining some of our concerns with S. 1992, the "Life Insurance Tax Act of 1983."

Specifically, we object to the inclusion of Sections 223 and 224 of the bill as these two sections impact on individual policyholders and not on the companies. Additionally, we feel these provisions would impact unfairly on policyholders, particularly retirees and those on fixed incomes.

An additional concern of ours would be the impact of limiting interest deductions for borrowers, particularly those who are required to carry life insurance on their notes, such as persons borrowing from the Small Business Administration and the Farmers Home Administration.

The purpose of S. 1992, of which these two provisions are a part, is to simplify and rationalize the tax treatment of life insurance companies and to raise additional tax revenues from the life insurance industry. Sections 223 and 224 relate to the owners of life insurance products rather than to life insurance companies and are non-revenue items.

We urge your support for deletion of these two sections.

Thank you.

A Written Statement Prepared by
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Interest Deductions and Life Insurance Policy Loans

by Norma Nielson, Ph. D.

The Tax Treatment of Policy Loans

Today's policy loan provision generally allows the policyowner to borrow against the cash value of a life insurance policy at a fixed interest rate of 5% to 8%. This loan privilege was originally created to help policyowners meet "financial stringency" and to prevent expensive policy lapses. Earlier studies show the policyowners used the loan proceeds for purposes consistent with this.[1] This pattern began to change, however, in 1966, when policy loan interest rates were exceeded by short-term consumer borrowing rates for the first time in history. With this inversion of the relationship between short term consumer borrowing rates and policy loan interest rates a fundamental change occurred in the way SOME policyowners view their loan privilege. The following expanded list of policy loan uses was given by Kraegel and Reiskytl in their comprehensive treatise on the subject:

> 1. Short-term borrowing--May be used whenever required or desired expenditures are greater than available funds, if the interest rate is the best

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[1] . See, for example, Henry S. Nollen, "Recent Fluctuations in Policy Loans," Proceedings of the Association of Life Insurance Presidents, (1921) and Glenn L. Wood, "Life Insurance Policy Loans: The Emergency Fund Concept," Journal of Risk and Insurance. Volume XXXI, (September 1964), pp. 411-20.

available, if credit from other sources is difficult to obtain, or if greater confidentiality desired. The specific purpose might be for premiums, taxes, business inventories, automobiles, vacations, or a myriad other uses. Short-term borrowing often turns out to be long term because there is no pressure to repay.

2. Long-term borrowing--May be used to pay for a new home or for a business. This use is likely to be infrequent because few policyowners simultaneously have the substantial cash values, the long-term need, AND the willingness to reduce coverage by the loan amount.

3. Minimum deposit--May be used by some policyowners, particularly those in a high tax bracket, to finance premiums. Minimum deposit may take one of several forms, but essentially it involves paying four premiums out of the first seven (to satisfy the Internal Revenue Code requirement), borrowing all subsequent premiums, and paying all interest when due. The combination of an attractive interest rate and income tax deductibility of the interest paid provides low-cost life insurance, at least in its earlier years.

4. Arbitrage--May be used by some policyowners whenever they can borrow at the low policy loan rate and invest elsewhere at a higher rate. These borrowers are likely to continue the policy loan as long as the interest differential exists. [2]

The most complex of these new uses is minimum deposit. The applicability of policy loans to purchase life insurance through this method depends almost exclusively on the interest deduction allowed in the Internal Revenue Code.

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[2] Wilfred A. Kraegel and James F. Reiskytl, "Policy Loans and Equity," Transactions of the Society of Actuaries, Volume 29 (1977), pp. 61.

In general, the deduction for interest on indebtedness first appeared in the calculation of net taxable income under the 1861 income tax law.[3] Interest deductibility has been retained as a matter of Federal tax policy to promote investment in business and innovation (and because in early years it was often difficult to distinguish between business and personal loans). The law still allows deductions for interest paid regardless of whether borrowed funds are used for business purposes, personal consumption, home ownership, or investment (except in tax-exempt securities). The deductibility is unchanged even if the asset borrowed against is afforded a favorable tax treatment, as when a second mortgage is acquired against a principal residence. With respect to loans against a life insurance policy, tax law has been interpreted to mean that all interest actually paid on such loans is deductible by those reporting on a cash basis; interest accrued is deductible by those reporting on an accrual basis.

The most specific legislation with respect to the tax treatment of policy loans were the 1964 amendments to Section 264 of the Internal Revenue Code. These changes disallow an interest deduction for:

> "any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance ... contract ... pursuant to a plan of purchase which contemplates the systematic direct or borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).[4]

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[3] Roy C. Blakey and Gladys C. Blakey, The Federal Income Tax, Longmans, Green, and Company (New York, New York), 1940, p. 5.

[4] Internal Revenue Code, Section 264(a)(3).

Four exceptions to this general rule are permitted. The most important provides that if no part of four out of the first seven annual premiums is paid by borrowing, the deduction is permitted even if the borrowing follows a plan. The other exceptions which allow deductibility even under a systematic plan of borrowing are triggered if the amount involved does not exceed $100, is incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in financial obligations, or is incurred in connection with trade or business. These restrictions, particularly the so-called "four-out-of-seven" rule, were added to the law to reduce a policyholder's ability to finance a life insurance policy with tax-deductible interest payments on policy loans instead of with premium payments. The current proposal before Congress indicates a strong sentiment that this practice has not been adequately contained. But the question still remains as to the correct way to constrain what is being considered undesirable. A thoughtful, critical answer to this question must include a consideration of the impact of tax deductibility of policy loan interest on policy loan demand.

Forces Driving Policy Loan Demand

The nature of the uses of policy loans, as well as recent changes in their uses, have forced life insurers to accept a great deal of unpredictability in loan demand. The unpredictability of that demand has caused a policy loan "problem" for the life insurance industry for almost as long as policy loans have been generally available. Glancing through a bibliography of articles on the subject of policy loans, one can find similar titles for articles published on the "policy loan problem" during the 1910s, the 1940s, the mid-1970s, and the early 1980s.

A number of high-quality statistical studies in recent years have attempted to determine the forces influencing fluctuations in the demand for policy loans. Bykerk and Thompson concluded that "the demand for policy loans is related closely to the differential between the commercial paper rate and the policy loan rate.... This result supports the interest arbitrage hypothesis of Francis Schott [5]..." [6]

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[5] Francis H. Schott, "Disintermediation Through Policy Loans at Life Insurance Companies," Journal of Finance, Volume 26 (June, 1971), pp. 719-729.

[6] Cecil D. Bykerk and A. Frank Thompson, "Economic Analysis of the Policy Loan Privilege," Transactions of the Society of Actuaries, Volume 31 (1979), p. 278.

Kamath and Lin also found the difference between the short-term interest rate and the policy loan rate to have the most significant effect on the demand for policy loans. They found the negative relationship between aggregate policy loans and the monthly change in the Standard and Poor's 500 stock price index also to be significant.[7]

In fact, all of these recent studies have pointed toward arbitrage as the key force driving the demand for life insurance policy loans. These results are certainly important to consider when any change in regulation regarding policy loans is proposed.

Validity of the Rationale for the Proposed Changes

Changes in the tax treatment of life insurance policy loans have been proposed several times in recent years. Such proposals generated a great deal of controversy during the Carter Administration and now are being considered again. An argument offered by Assistant Secretary of Treasury John H. Chapoton in support of changes in the current tax treatment concurs with those research studies cited above. Chapoton states that "since interest paid by the policyholder to the company on the loan is deductible, a policyholder borrows against the policy simply to invest the proceeds elsewhere." In response to this type of logic, a proposal contained in the proposed life insurer tax law would eliminate the interest deduction for loan amounts exceeding $50,000 per taxpayer (but allowing twice that limit for a married couple filing joint returns).

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[7] Ravindra Kamath and Cheyeh Lin, "The Policy Loan Problem Revisited," CLU Journal, Volume 33 (October 1979), pp. 55-60.

But arbitrage uses are NOT an argument for changing the tax treatment of policy loans. Indeed, they are arguments against such a change. So long as taxpayers are allowed to borrow funds for investment from banks and other financial institutions without restriction on the deductibility of interest paid on such loans, equity and tax neutrality demand that loans from life insurers receive the same treatment.

Secretary Chapoton also offers a second argument: that the "safe harbor" offered by the tax treatment of life insurance policy loans "has been used by life insurance companies to market policies with a fixed schedule of borrowing that provide substantial tax advantages to the policyholder."[9] The implication is that the life insurance industry is taking unfair advantage of the American taxpayer in order to increase sales. However, a comparison of the

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[8] John E. Chapoton, *Statement Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means*, (May 10, 1983), p. 16.

[9] Chapoton, p. 10.

15 life insurance companies with the greatest amount of life insurance in force with the 15 companies showing the greatest increase in life insurance in force does not confirm this statement.[10] As Table 1 shows, the weighted average of policy loan ratios for the fastest growing companies is actually less than the same ratio for the largest companies. This means that the companies selling the most life insurance in the U.S. are not doing so by encouraging abuse of the policy loan privilege.

To summarize, the current treatment of life insurance policy loans is consistent with the treatment of all other types of loans under the Internal Revenue Code. Prohibitions against organized borrowing to purchase life insurance are already in place and can be changed as necessary to meet abuses in the system. The fundamental philosophy embodied in the current treatment is sound and should not be considered for change unless the deductibility of interest paid on second mortgages, increases in brokerage margin accounts, etc. are also changed. To do so would mark life insurers as "different" in a financial marketplace where deregulation is flourishing and all forces seem to point to "sameness."

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[10] The top 15 companies (by life insurance in force) includes 54% of the industry's assets.

Equity and Effectiveness of the Proposed Change

The second serious problem with the proposed legislative solution to policy loan abuses is its uneven treatment of different types of policyowners. In its rush to close a perceived loophole for individual policyowners, the Congress is apparently forgetting that large amounts of life insurance are purchased under split dollar and other employee benefit plans for key personnel of corporate America. The design of this vital benefit will have to be completely rethought if the current proposal becomes law.

The proposed change would be counter to the purpose stated for some other recent changes. Specifically, changes in the Tax Equity and Fiscal Responsibility Act (TEFRA) were specifically tailored to equate the tax treatment of self-employed individuals with incorporated business. The current proposal would allow a large corporation the same $50,000 loan limit as a small business or an individual taxpayer. This is a complete reversal of the philosophy expressed in the 1982 law. A limit on loan interest per taxpayer would encourage small business to incorporate by allowing one loan deduction on the individual's return and another on the corporate return. A firm with one person receiving permanent life insurance would have the same limits as a firm with twenty or a hundred employees covered by such plans. As a minimum, the proposed restriction on the deductibility of policy loan interest need to be amended to a limit "per insured per taxpayer", rather than simply "per taxpayer".

Conclusion

In summary, I do not believe the cap on policy loan amounts eligible for interest deductions as proposed in S. 1992 is the proper approach to curtail abuses which have occurred under the existing "four-out-of-seven" rule for policy loans. It creates inequities and new opportunities for circumvention while the stated objective of the law's drafters has been to "create a level playing field." The current law embodies a philosophy which allows taxpayers to finance their investment or consumption with borrowing which is in turn subsidized by a tax reduction. No logical reason exists for differentiating that treatment depending on whether the taxpayer is purchasing a home, a personal computer, or a life insurance policy. If abuses exist, the definition of "organized borrowing" should be changed, not the way in which life insurers are treated relative to other lenders or to other retailers.

Table 1
Policy Loans as a Percentage of Life Insurance Reserves
Top Ranking Life Insurance Companies

	Insurance In Force		Increase in Insurance In Force	
Company	1982 Rank	Loan Ratio*	1982 Rank	Loan Ratio*
Prudential	1	14.9%	2	14.9%
Metropolitan	2	11.6%	1	11.6%
Equitable	3	33.3%	--	--
Aetna Life	4	20.0%	6	20.0%
New York Life	5	37.8%	7	37.8%
John Hancock	6	23.9%	--	--
Trans. Occidental	7	26.1%	3	26.1%
Travelers	8	25.9%	4	25.9%
Connecticut General	9	26.5%	14	26.5%
Lincoln National	10	26.2%	5	26.2%
Northwestern Mut.	11	41.4%	8	41.4%
State Farm	12	21.3%	13	21.3%
Massachusetts Mut.	13	44.8%	--	-
Mutual Benefit	14	44.5%	--	-
Minnesota Mutual	15	25.2%	11	25.2%
Phoenix Mutual	--	--	9	52.6%
Guardian Life	--	--	10	38.4%
Executive Life	--	--	12	18.7%
Penn Mutual	--	--	13	39.5%
Connecticut Mutual	--	--	15	42.6%
Weighted Average		24.39%		23.67%

*Ratio of 1981 Policy Loans to 1981 Life Insurance Reserves

Source: "The 50 Largest Life Insurance Companies," Fortune (June 13, 1983), pp. 166-167 and Best's Life and Health Insurance Reports (1982).

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TELEPHONE: 773-8066

December 30, 1983

Mr. R. A. DeArmant
Chief Counsel - Committee on Finance
219 Dirkson Senate Office Building
Washington, D. C.   20510

Re: January 27 Hearing on Senate Bill 1992

Dear Mr. DeArmant:

I would like an opportunity to testify at the above hearing for about 15 minutes. Enclosed is a copy of the testimony that I gave when Representative Pete Stark's subcommittee held a hearing on the House version of this bill.

Generally, you will find that my point of view differs substantially from others in that I feel that the insurance industry has abused the inside build-up of cash values on life insurance policies and the deductibility of interest on policy loans. I feel that the simplest way to curb this abuse is to substantially limit the deductibility of interest on life insurance loans.

There is another concern I have--that some of the products being devised by the insurance companies are specifically designed to encourage payment of premiums by increased policy loans each year. Although I am not familiar with the method of taxing life insurance companies, it seems that the companies can deduct an amount equal to the reserve on a Whole Life contract. When the insured has borrowed the cash value of the policy, there is no longer a need for reserve on such a policy; thus, the deduction for the non-existent cash value should not be allowable.

Some of my fellow agents question my calling such practices to the attention of Congress; however, I do not feel that it is morally right to see an industry devise products which, in effect, shift a tax burden from those in high tax brackets to the general public.

I realize that I will have to come to Washington at my own expense, but I am perfectly willing to do so. A copy of my credentials is attached.

Sincerely,

Thomas M. Dabbs

Thomas M. Dabbs, CLU, ChFC

TMD/stm
Attc. - 2

TESTIMONY TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

May 10-11, 1983

The Honorable Fortney H. (Pete) Stark, Chairman

Testimony given by: Thomas M. Dabbs, C.L.U., Ch.F.C.
Post Office Box 147
Sumter, South Carolina 29150
Telephone: 803-773-8066

Appearing as an individual.

1. The need for additional revenue by the government is a problem that should be addressed by responsible citizens as well as by members of Congress.

2. In our society, life insurance is very desirable as it provides family and business security as well as capital for investment.

3. Insurance premiums are paid with "after-tax dollars" which inflation has made more and more difficult to acquire.

4. The present tax-free accumulation of the cash values inside a life insurance contract is desirable as such earnings offset some of the cost of the insurance protection and should encourage saving by the insured.

5. Taxation of the inside build-up of cash values would cause many problems:

    a. The insurance industry would have the tremendous burden of providing an annual print-out to each policyholder showing the tax liability he has for that year.

b. Some agency would have to establish a realistic cost for term insurance--a difficult figure for insurance companies to determine even at present.

c. The insured will be encouraged to offset the taxable income by borrowing against his policy in order to get a tax deduction for the interest charged.

d. An income tax liability on cash values will encourage the public to buy term insurance andforego permanent protection.

6. In my opinion, the tax-free build-up of cash value has been abused in the following manner:

Initially, the deductibility of interest on policy loans permitted an insured in the 35% or higher tax bracket to make maximum loans and have a net outlay less than the cost of term insurance.

The insurance industry then developed products allowing the insured to make loans to pay the premiums, make another loan in the amount of 50% of the interest charged and thereby have the same cash flow that would have existed had the policy not been purchased. Had the policy not been purchased, the insured would have had to pay income taxes on more reportable income. The net result is that the life insurance company receives money as interest, rather than the government receiving this money as taxes. Some call this the "government pay all" plan.

Currently, products are being designed so that the purchaser can recover all of his outlay at the end of the eighth year. These plans are being sold as group products, so that individual states do not have control of the interest charged on policy loans. Generally, the charge is that of Standard and Poor's average interest rate over the past quarter on AAA bonds. Such interest is fully deductible by the owner. However, the cash value is given credit as a tax-free build-up of interest charged less 3/4 of one per cent. If the rate of interest on the loan is 12%, credit for cash value earning is 11¼%. The sales pitch is to encourage the owner to pay a high rate of interest which is fully deductible, but the owner get income-tax-free build-up at a higher rate of interest. This approach has been responsible for the purchase by individual corporations of policies with annual premiums in the millions of dollars.

Bache-Prudential has had seminars for those in a high income tax bracket to show how life insurance contracts can be used as a tax shelter and can throw off "income tax free" payments.

Recommendation:

The problem is not the tax-free build-up of cash value, but rather the deductibility of interest on life insurance policy loans. Denial of such interest deductions has the following merits:

a. It is a very simple procedure.

b. Congress has already denied deductibility of interest on loans made to purchase single premium life insurance contracts.

c. Congress has already considered this problem, but permitted an exception in situations where the purchaser paid four out of the first seven annual premiums. (The exception did not say four out of ten, fifteen, or twenty, but the industry has operated on the theory that once a purchaser qualifies by paying four out of the first seven premiums, then interest charged on loans to pay future premiums is a deductible item.)

d. It is a fair approach as the owner has income-tax-free accumulation of cash values during his lifetime and the beneficiary has tax-free receipt of the proceeds.

e. Restriction of interest deductions follows a trend which the Treasury Department is trying to develop.

f. The restriction of interest deduction on policy loans will encourage policy owners to leave cash values intact and thus create more savings for investment by the insurance companies.

At one time, life insurance companies restricted the investment of their reserves to mortgages, bonds and some select stocks. Recently, however, their investments include outright ownership of business ventures such as shopping centers and office complexes. Insurance companies have also entered into joint ventures with others--such as Marriott Hotels--in which the insurance company has equity in the joint project.

It would seem that income generated by such investments that build equity would be taxed in a different manner than investments made in bonds and mortgages, etc. When a mutual company purchases property, that property never goes through an estate; no estate tax is ever generated on such assets.

You might consider encouraging insurance companies to invest in some public type of project such as low rent housing, water and sewer bonds or Farmers Home Administration loans--projects now financed by government funds. It would seem that the income from investments made for socially desirable projects would be taxed at a lower rate than investments made for an equity position.

February 15, 1984

STATEMENT OF
SUN LIFE ASSURANCE COMPANY OF CANADA (U.S.)
AND
MASSACHUSETTS FINANCIAL SERVICES
ON
THE TREATMENT OF ANNUITY POLICYHOLDERS AND
VARIABLE CONTRACTS UNDER S. 1992 --
THE LIFE INSURANCE TAX BILL OF 1983
TO
COMMITTEE ON FINANCE
UNITED STATES SENATE
JANUARY 31, 1984

This statement is submitted by Sun Life (U.S.) Assurance Company of Canada (U.S.) ("Sun Life (U.S.)"), a wholly-owned subsidiary of Sun Life Assurance Company of Canada, and by Massachusetts Financial Services ("MFS"), a wholly-owned subsidiary of Sun Life (U.S.).[1] Sun Life (U.S.) is currently the leading issuer of individual variable annuity contracts in the United States, and MFS is the wholesale distributor of Sun Life (U.S.)'s annuity policies to stock brokerage firms and insurance broker-dealers. This statement addresses two portions of S. 1992 of deep concern to Sun Life (U.S.) and MFS: the proposed changes in the treatment of annuity policyholders, and the proposed taxation of capital gains credited to both variable life and variable annuity contracts.

Sun Life (U.S.) believes that the proposals to extend the 5 percent penalty on withdrawals from annuity contracts and to include policy proceeds in the income of annuity owners who die prematurely are unnecessary and ill-conceived, and should be deleted from the bill. The attractiveness of annuity contracts has been undercut by recent legislative and administrative changes in the tax treatment of such contracts, and public confidence in annuities has been shaken by the recent insolvency of a major issuer. The annuity policyholder provisions of S. 1992 would further discourage annuity purchases. Yet annuities fill an important role in the U.S. policy of encouraging individuals to save for their retirements and to provide for the welfare of their surviving spouses and children. The recent legislative changes in tax treatment adequately assure that annuities will be used for these purposes and not as short-term investment vehicles. In these circumstances the purchase of annuities should be encouraged, not further discouraged. Moreover, the proposed changes would not produce any significant revenue gain; indeed, they would most likely depress sales, reduce company-level taxable income, and thereby cause a loss of revenue.

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[1] Sun Life (U.S.) and MFS are referred to collectively herein as "Sun Life (U.S.)."

Sun Life (U.S.) also opposes the proposal to continue the double tax on capital gains realized by a segregated asset account supporting variable annuity policies. This treatment represents the perpetuation of an historic anomaly that unfairly discriminates against variable annuity products in favor of other annuity products. Further, Sun Life (U.S.)

objects to the proposed extension of this treatment to variable life products, thereby creating a competitive disadvantage for such policies relative to other types of life insurance policies. The latter is particularly inappropriate in light of the definitional provisions of S. 1992 that would insure against the use of variable life products primarily as investment vehicles.

Finally, Sun Life (U.S.) supports the legislative reversal of Revenue Ruling 81-225.

I. Annuity Policyholder Provisions

Deferred Annuities Generally

Under a deferred annuity contract, the annuity starting date occurs after the date the contract is issued. During the period between the issue date and the annuity starting date (*i.e.*, the "accumulation period"), the premium deposits of the purchaser are credited to an account which either accumulates interest credited by the company (in the case of a fixed annuity) or fluctuates in value with reference to the performance of a segregated investment account (in the case of a variable annuity). At the annuity starting date, the accumulated value of the contract account is applied to fund the annuity payments based on annuity purchase rates guaranteed when the contract was issued (or, in certain cases, on the currently-offered immediate annuity purchase rates if better than the guaranteed rates). Annuity payments may be fixed or variable depending on the terms of the contract.

Prior to the annuity starting date, the owner of a deferred annuity typically may surrender the entire contract for its surrender value. In such a case, a surrender charge is often imposed by the issuer. Many contracts also provide for partial surrenders, and generally annuity contracts may be pledged as collateral for loans.

1. Section 222(a): Surrenders Prior to Annuitization

a. Current law

Section 72 of the Internal Revenue Code of 1954 (the "Code") provides comprehensive rules governing the taxation of distributions under annuity contracts. Income accruing under a deferred annuity contract during the accumulation period is not taxed currently to the contract owner (unless it is withdrawn, as described below). When the contract annuitizes (*i.e.*, when annuity payments commence), a fixed portion of each payment is taxed as ordinary income to the annuitant, so that the accumulated earnings under the contract are included in taxable income over the annuitant's expected life.

In 1982, Congress enacted the Tax Equity and Fiscal Responsibility Act ("TEFRA"), significantly tightening the traditional rules governing the taxation of distributions under annuity contracts. Prior to TEFRA, partial surrenders from annuities were treated as coming first from premium investments, and hence were not taxable to the owner until the amount withdrawn exceeded the aggregate premiums paid.

Further, no income tax arose when loans were taken against the contract's value.

TEFRA amended Section 72(e) to provide, first, that all pre-annuitization amounts withdrawn are deemed to come first from taxable accumulated income, and hence, to this extent, are taxed to the contractholder as ordinary income. Second, after TEFRA, policy loans, as well as loans collateralized by the annuity contract, are treated as distributions subject to this rule. Finally, TEFRA added Section 72(q) to the Code, imposing a five percent penalty on taxable distributions that are received prior to age 59-1/2 and that are attributable to investments made during the preceding ten years.[1]

Congress made these changes because it was concerned about the use of annuities as short-term investment vehicles, and wanted to discourage early (pre-annuitization) withdrawals. At the same time, however, Congress recognized that the traditional use of deferred annuities "to meet long-term investment and retirement goals . . . [is] a worthy ideal." Joint Committee on Taxation, General Explanation of the Revenue Provisions of TEFRA, page 361 (1982).

b. Proposed changes

Section 222(a) of S. 1992 would repeal the "ten year" exception to the five percent penalty, and hence would apply the penalty to any amount distributed to the taxpayer prior to age 59½, without regard to whether the distribution is allocable to an investment made within the preceding ten years.

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[1] The penalty is not imposed where the policy owner is disabled, where distributions are made in substantially equal payments for life or over a period of at least 60 months beyond the annuity starting date, or where distributions are made after the death of the annuitant.

Sun Life (U.S.) opposes this unnecessary change. As noted above, Congress added the five percent penalty to Section 72 little over a year ago. That change, which reflected extensive discussions among Congress, the Treasury Department and the industry, was viewed as a comprehensive and permanent resolution to the perceived problem that would not interfere with the legitimate use of deferred annuities to meet "long-term investment and retirement goals."

The ten-year provision discourages short-term investment in annuity contracts without unnecessarily discouraging their purchase due to the inability to meet later financial emergencies or other unanticipated needs. The elimination of this flexibility would reduce the attractiveness of the deferred annuity to individuals younger than age 50. Yet these are the very people who should be encouraged to purchase annuities policies to provide for retirement, thereby reducing what is becoming an intolerable burden on the Social Security system.

In reliance upon TEFRA's comprehensive changes, annuity issuers, including Sun Life (U.S.), altered at great expense their methods of business. S. 1992 would again revise the rules, further discouraging the purchase of annuities and putting issuers to the further expense of responding. Yet we are aware of no evidence that the TEFRA changes -- including the ten-year provision -- have not effectively accomplished their purpose of discouraging short-term investment through annuity contracts; it is simply too early to say that the proposed repeal of the ten-year provision is necessary. There is no doubt, however, that the proposal would further discourage younger individuals from purchasing deferred annuities. For that reason, the provision should be removed from the bill.

3. Section 222(b): Inclusion of Proceeds at Death

a. Current Law

When the owner of an annuity dies prior to annuitization, the contract's surrender value is included in his estate, and hence is subject to estate tax. Further, the death beneficiary, who is entitled to receive the amounts remaining in the contract, is subject to income tax.

Typically, the beneficiary is entitled to elect to receive the proceeds either as a lump sum or as an annuity. If the beneficiary elects a lump sum settlement, the investment income accumulated under the contract is included in the beneficiary's income at that time; if the beneficiary elects an annuity, annuity payments are includible in the beneficiary's income when received, under the rules of Section 72.

b. Proposed changes

Under Section 222(b) of S. 1992, where a contract owner dies prior to the annuity starting date, all of the deferred income under the contract would be included in the decedent's final income tax return. Since the decedent's final income tax liability is payable by his estate, the provision would deplete the residuary estate to the detriment of the residuary legatees, who may not be the recipients of the beneficial interest in the contract. Section 222(b) would thus reverse well-established taxation rules of general application[1] by taxing all of the investment income earned under an annuity contract to the decedent immediately upon his death, rather than taxing the income to the beneficiary as received. This change would effectively require that the contract proceeds be distributed in their entirety upon the pre-annuitization death of the contract owner.

The ostensible purpose of this proposal is to prevent the tax deferral provided by an annuity contract from continuing indefinitely. This inclusion of proceeds at death, however, would impose a financial hardship triggered by an unplanned event, i.e., the premature death of the head of household, penalizing survivors by compressing in one year income that would otherwise be received over time. This would be particularly onerous for the typical annuity contract purchaser, who is a middle-income individual.[2]

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[1] Under Code § 691 (income in respect of a decedent), where a decedent has earned income which was not includible in his income prior to death, the taxpayer who inherits the right to that income pays tax on the income when received.

[2] The average annuity contract issued by Sun Life (U.S.) has an initial purchase payment of less than $15,000.

Ironically, the rule would indiscriminately penalize those not seeking undue deferral, including the very type person who should be encouraged to purchase an annuity contract. Consider, for example, a man, who, at age 50, purchases a single premium deferred annuity contract to provide for his and his wife's retirements. The contract is scheduled to annuitize at age 62, the man's expected retirement age, and thereafter supplement his pension. If, at age 58, the man dies unexpectedly, the full amount of the investment income under the contract would be included in his final income tax return, and hence would be subject to income -- as well as estate -- tax at a time when the family can least afford it. There is no conceivable justification for subjecting people in these circumstances to the sort of punitive taxation thought necessary to prevent others from extending unduly the deferral under an annuity contract.

Moreover, the need for such a change in the treatment of pre-annuitization death is questionable at best. First, it is perfectly clear that under current law every investment dollar earned under an annuity contract will be subject to income tax. Although current law permits postponement of annuitization beyond the death of the owner, this flexibility is necessary in order to meet the varying circumstances of the decedent's family. Since the families involved are typically of modest means, it is predictable that they will require the annuity proceeds at some time during the life of the surviving spouse and the minority of any surviving children. It is unnecessarily harsh to deprive these people of the opportunity to plan their financial affairs in the wake of the premature death of the head of the household.

The rule would also result in inconsistent treatment of similarly situated taxpayers: a taxpayer who is killed suddenly will not have the opportunity to annuitize and thereby avoid the penalty, while a taxpayer with a fatal but lingering illness will have the opportunity to avoid the inclusion of the large amount of income in his final return. Such inconsistent treatment is incompatible with sound tax policy.

Finally, the provision as drafted, by looking to the "owner" of the annuity policy, ignores the possibility of joint ownership and would encourage all manner of artificial ownership arrangements. For instance, an annuitant presumably could avoid the rule simply by placing his annuity policy in a corporation, which will never die. Indeed, corporate ownership of annuity contracts is quite common.

For the above reasons, Sun Life (U.S.) believes that the proceeds at death provision should be deleted entirely from the bill. It is ill-conceived, it discourages the purchase of annuity contracts, and it needlessly penalizes premature deaths, hurting the decedent's beneficiaries at the time they can least afford it.

Sun Life (U.S.) understands that the proposed proceeds-at-death provision was added to the life insurance bill reported by the House Ways and Means Committee (H.R. 4170) as a substitute for a rule in an earlier proposal which would have required distributions under an annuity contract to begin at age 70½. While objecting to excessive deferral, the Treasury Department has recognized that both the original proposal and the current substitute are "overly restrictive." Statement of John Chapoton, Assistant Secretary (Tax Policy) before the Senate Finance Committee, January 31, 1984.

If the Finance Committee accepts Treasury's invitation to fashion a more reasoned response to the deferral problem, a better solution would require a nonspousal beneficiary to annuitize the contract within a certain period after the death of the owner, but only where death occurs after age 70½. This would alleviate the "bunching" hardship and remove the penalty on "innocent" taxpayers who die prematurely, while at the same time curing the "endless deferral" problem.[1]

II. Treatment of Variable Contracts

1. Variable Annuities

a. Current Law

As noted above, premiums paid under a variable annuity contract are invested in a separate asset account.

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[1] Under this scheme, successive generations of beneficiaries could avoid annuitization and thereby continue deferral only by arranging for each previous generation to die before age 70½. This is hardly an abuse that could -- or would -- be fostered through effective tax planning.

The cash value of each contract is determined by reference to the overall performance of the separate account. When the policy starting date is reached, the accumulated value is applied toward the purchase of an immediate annuity.

As the result of an offsetting reserve deduction, ordinary income (interests and dividends) received by a separate account under a variable annuity contract is not subject to tax at the company level. The reserve deduction is permitted because income received by the separate account will ultimately be paid to the contractholder, and will be subject to tax at that time.

An offsetting reserve deduction is not permitted, however, for capital gain income earned by a separate account on non-qualified annuity contracts, notwithstanding that all such gains realized must also ultimately be paid to the policyholders. Thus, under present law, the insurance company pays tax at capital gains rates (generally 28% for long-term gain and 46% for short-term gain) on gains realized in the separate account. When these gains are later distributed to the contract owners, annuitants or beneficiaries, they are taxed again, this time as ordinary income. The result is that amounts credited to a variable annuity as the result of the appreciation in value of assets in the separate account are taxed twice: once at the company level at the capital gains rate, and again to the contractholder as ordinary income.

b. Proposal

Proposed Code § 817 would retain the existing double taxation of capital gains realized under variable annuity contracts. Preservation of this tax treatment, however, is clearly inappropriate.

As a result of the capital gains tax, insurance companies maintain a reserve in the segregated asset account equal to 28% of all realized and unrealized appreciation. This reserve is charged against the account values of the variable contract owners. Thus, contrary to the intended effect of Section 72 (which contemplates that income accumulated under an deferred annuity contract will not be taxed until distributed to the policyholder), the proposal continues in effect to impose on the variable contractholder a current capital gains tax at corporate rates on that portion of the increase in cash value of his or her contract attributable to the appreciation in the underlying account.

The double tax would not arise, however, to the extent that the insurance company is able to invest the variable annuity premiums in assets giving rise to ordinary income rather than capital gain. As a matter of tax policy, it should be irrelevant whether variable annuity premiums are invested in assets which produce capital gain or in assets which produce ordinary income. There is no reason to encourage investment in the latter; indeed, if anything, the capital gains deduction permitted by the Code indicates that long-term investments are to be preferred.

The House Ways and Means Committee and the Treasury Department have suggested that the double tax should be retained to equalize the tax treatment of insurance products based on investment funds and direct investment in such funds. This suggestion ignores many other differences that distinguish annuity contracts from investments in mutual fund shares. For instance, the annuity contractholder has a guarantee of a lifetime income stream for which he is charged a premium. Further, the rights of the annuity contractholder at death pass under state law without administration by the executor of the estate.

In addition, there are significant tax differences between an investment in a variable annuity and direct investment in mutual fund shares. As discussed above, an annuity contractholder, unlike an investor in mutual fund shares, is subject to a penalty tax if he withdraws his investment in the contract within ten years. Further, distributions out of capital gains earned by the segregated asset account are taxed to the contractholder as ordinary income, whereas the character of capital gains realized by a mutual fund is passed through to the shareholder. In addition, the basis of mutual fund shares after the death of the owner is their market value at the time of death, but the basis of an annuity contract does not change. Finally, the exchange of shares in one mutual fund for shares in another gives rise to recognized gain or loss, whereas Section 1035 permits the tax-free exchange of annuity contracts.

These differences flow from the fact that investors buy annuities to meet future retirement needs, not to meet short-term investment goals. These distinctly different investment objectives make it inappropriate to suggest that the treatment of annuities and mutual fund shares should be equalized, or that investment parity between the two would be accomplished simply by retaining the capital gains tax on annuities at the company level.

In short, even absent a company-level tax, none of the income accumulated under a deferred annuity contract would escape taxation: every dollar earned -- including capital gains -- is taxable to the policyholder as ordinary income when received. Accordingly, the continued imposition of an implicit penalty on variable annuity contracts is simply unwarranted.

2. Variable Life

a. Current law

A variable life contract is similar to a variable annuity in that premiums are invested in a separate account. Unlike a variable annuity, however, variable life provides life insurance protection in the form of a death benefit, the amount of which fluctuates (but not below a certain amount) with the investment performance of the separate account.

Under current law, the double taxation scheme governing variable annuities does not apply to variable life contracts. Although the company is taxable on the realized appreciation of the assets of the underlying separate account, the company is allowed an offsetting deduction for such appreciation when it is credited to the variable life insurance contract. As with other life insurance contracts, the policyholder is, upon surrender, taxed on the income accumulated under the contract. If the contract terminates with the insured's death, the proceeds are normally excluded from the gross income of the beneficiary.

b. Proposal

Proposed Code § 817 would reverse current law and impose a tax at the company level on capital gain realized in a segregated asset account supporting a variable life policy without permitting an offsetting deduction for appreciation credited to the contract. Such a change represents an unwarranted departure from the most fundamental aspect of life insurance company taxation: amounts credited under a life insurance contract for ultimate distribution to the policyholder (*i.e.*, the "inside build-up") accumulate tax-free.

The proposal would, in effect, discriminate against variable life in favor of all other life insurance products. Under S. 1992 as applied to life insurance products generally, investment income -- including capital gains -- is offset by a deduction for reserve additions, and hence is effectively free from tax at the company level. Thus, all forms of investment income for such life insurance products, including capital gains, can be passed on to the policyholders without diminution on account of tax at the company level. Only in the case of variable contracts would this rule be inapplicable.

The proposal would also discriminate among variable life contracts on the basis of the investments chosen by the segregated asset account. If the account were to invest in assets producing ordinary income, no company-level tax would be imposed; if, on the other hand, the account were to invest in assets producing capital gain, such gain would be subject to tax at the company level, reducing the benefits payable under the policy.

The purported justification for company-level capital gains taxation of variable annuity contracts under current law is that variable annuity contracts are competitive with certain investment products. Whatever the merits of that position, the proposed change in the treatment of variable life is entirely inappropriate on that basis since variable life is not an investment vehicle, but a form of life insurance designed to provide protection in the case of death. Variable life essentially permits policyholders to have their life insurance coverage adjusted to meet current economic conditions, particularly in times of inflation. Unlike a mutual fund, in which investment return is reflected dollar-for-dollar, variable life converts each dollar of favorable investment experience into multiple dollars of additional life insurance. As a life insurance product, variable life involves the usual mortality and expense charges. Thus, unlike a mutual fund shareholder, if a policyholder surrenders his variable life policy after a period of favorable investment experience, the surrender value will not reflect all of this investment income, since a significant part would have been applied to provide additional life insurance protection.

Moreover, variable life insurance is subject to the definition of "life insurance" contained in S. 1992, which excludes investment-oriented products from favorable life insurance treatment. The safeguards applied by this definition would effectively eliminate any possibility of an excessive investment component in the case of variable life insurance.

This sentiment has been echoed by Assistant Treasury Secretary Chapoton. In his testimony before the Senate Finance Committee, Secretary Chapoton recognized that variable life policies are not pure investment vehicles, and that, accordingly, company-level taxation of capital gains supporting variable life contracts would be inappropriate.

In short, variable life insurance is intended to provide basic life insurance protection and not investment return; no one interested purely in fund accumulation would buy this product. Hence, capital gains realized under variable life policies should not be subject to company-level tax.

3. Revenue Ruling 81-225

Sun Life (U.S.) wishes to add its support to the proposal of the Investment Company Institute that Congress legislatively overrule Revenue Ruling 81-225, thereby permitting variable annuity contracts to be based on publicly held mutual funds.

In Revenue Ruling 81-225, the Service took the position that, where a segregated asset account invests in shares of a publicly available mutual fund, the individual owning the variable contract will be treated for tax purposes as the direct owner of the mutual fund shares held by the insurance company. In that case the owner would be currently taxable on income distributed by the mutual fund.

The operative premise of Revenue Ruling 81-225 was that direct investment in shares of a mutual fund and ownership of a variable annuity contract funded through the same mutual fund shares are interchangeable forms of investment, and hence should be treated alike for tax purposes. This analysis simply ignores the significant differences between investment in variable annuities and direct purchase of mutual fund shares. In particular, TEFRA, which was enacted subsequent to the publication of Revenue Ruling 81-225, materially altered the income tax rules relating to annuity contracts. Despite these significant changes -- including the imposition of the 5% penalty tax on premature withdrawals -- the Service has refused to alter its position set out in Revenue Ruling 81-225.

Further, a federal district court judge recently declined to follow Revenue Ruling 81-225. Christoffersen v. United States, No. C 82-206 (N.D. Iowa 1984). The certain prospect of further litigation and prolonged uncertainty makes a legislative resolution even more imperative.

January 31, 1984

STATEMENT OF THE STOCK COMPANY INFORMATION GROUP
BEFORE THE SENATE COMMITTEE ON FINANCE
CONCERNING THE VARIABLE CONTRACT AND
POLICYHOLDER TAX PROVISIONS OF S. 1992

The Stock Company Information Group appreciates this opportunity to submit comments to the Committee on Finance respecting the variable contract and policyholder tax provisions of S. 1992.

The Stock Company Information Group consists of 26 investor-owned life insurance companies. Taking into account its members' affiliated companies, the Group includes 29 of the 50 largest life insurance companies in the United States. */ The Group was organized in 1981 to monitor tax legislative developments and convey to the various life insurance company trade associations, and to the Government, the views of its membership on life insurance tax issues. Our representatives were privileged to work with members and staff of the Ways and Means Committee of the House of Representatives in formulating the life insurance tax provisions currently embodied in the House counterpart legislation, Title II of H.R. 4170. We look forward to working with this Committee in its consideration of S. 1992.

Prompt enactment of this legislation is critically important to the life insurance industry and its policyholders,

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*/ A complete list of member companies is appended to this statement.

and we offer this Committee our full cooperation in realizing that objective. The Stock Company Information Group endorses the overall legislative package contained in S. 1992, and we wish to commend Senators Bentsen and Chafee for their sponsorship of the bill. We trust that the limited comments we have to offer on S. 1992 will assist, not hinder, the Committee in moving this legislation towards enactment.

Before proceeding to matters of variable contract and policyholder taxation, we wish to express our view that S. 1992 will significantly simplify and improve the law governing taxation of life insurance companies, eliminating a number of special provisions of existing law. Some of the provisions to be eliminated, however, were designed to achieve a variety of objectives, including forbearance from taxing mutual life insurance companies on the amount of the "redundant" premiums they "rebate" to their policyholders, ensuring (as a related matter) that stock life insurance companies would not bear a disproportionate share of the industry tax, and also ensuring that the life insurance industry, as a whole would not be significantly overtaxed.

In different ways, S. 1992 contains features designed to fulfill these same objectives. For example, the mutual company "addback" of proposed section 809 of the Code is designed to accomodate the competing objectives of allowing mutual life insurance companies to deduct the rebate of the redundant portion of their premiums, while foreclosing their ability to "dividend out" corporate level earnings to their policyholders free of tax. We regard proposed section 809 as an essential feature of S. 1992.

Similarly, to assure industry taxation at an appropriate overall level, S. 1992 contains two special deductions, a "small life insurance company deduction" and a "special life insurance company deduction." The latter, available to all life insurance companies, is equal to 25 percent of a company's taxable income. It is estimated that the new statute, with these special deductions, will produce about $2.9 billion from the life insurance industry in 1984, an amount that we consider to be both ample and appropriate.

Finally, we have come across what appear to be several technical problems with the company tax provisions of the proposed statute. We have informed the Committee staff about these problems, and we look forward to working with the Committee to cure these flaws.

We now turn to the variable contract and policyholder tax provisions of S. 1992. With respect to variable contracts, we are quite troubled by the provisions of the bill that effectively would double-tax capital gains allocable to variable annuity contracts, as under existing law, and would extend that treatment to variable life insurance contracts. These provisions need to be changed. On the other hand, we are pleased to endorse the policyholder tax provisions of S. 1992, our concerns being limited to a few, reasonably discrete matters.

We will focus on the variable contract issue first. Thereafter, we will offer some observations on (1) the new definition of a "life insurance contract," (2) the proposed treatment of nonqualified deferred annuities on the death of a contractholder, and (3) the proposed amendments to the rule governing the deductibility of interest paid on policy loans.

Capital Gains Under Variable Life Insurance and Annuity Contracts

Variable life insurance and variable annuity contracts play an important role in the provision of life and income protection. Under a variable life insurance policy, both the death benefit and the cash value may vary, depending upon the investment performance of a "segregated asset account" or "separate account." Similarly, the value of a variable annuity contract fluctuates with the performance of a separate account. Through the separate account, gains and losses attributable to designated assets are allocated to a specific portion of the issuing company's business, even though the policyholders have no actual ownership interest in those assets. But, because their benefits vary with the separate account results, holders of variable contracts may obtain insurance and income protection without having to sacrifice the opportunity to participate in asset gains. Nevertheless, the issuing company continues to bear the mortality risks involved.

We endorse the inclusion of variable life insurance under the definition of a "life insurance contract," as proposed in section 221 of S. 1992. That definition would confirm the treatment of variable life policies as "life insurance," provided, of course, that the generally applicable statutory tests are met. In our view, those tests would foreclose the use of variable life policies primarily for investment rather than as insurance.

On the other hand, the Stock Company Information Group believes that variable life insurance and variable annuity contracts would be unfairly penalized if new section 817 of the Code were enacted as proposed in S. 1992. Existing section 801(g)(6) of the Code -- unjustifiably in our view -- imposes double taxation on asset gains attributable to "nonqualified" variable annuities (i.e., variable annuity contracts not issued in the context of tax-qualified pension or profit-sharing plans). Under new section 817, this treatment would be preserved for nonqualified variable annuities, and would be extended to variable life insurance as well. If the existing treatment of variable annuities were ever appropriate, it no longer is. Worse, the extension of that treatment to variable life is simply unwarranted.

The double taxation of asset gains attributable to variable annuities is grounded in -- and has been overtaken by -- history. Life insurance companies may deduct the annual increase in their future liabilities represented by "life insurance reserves," and must include in income any annual decrease in those reserves. This treatment has long prevailed under existing law, and would be carried forward under S. 1992. When variable annuities were first developed, the industry assumed that reserves for variable annuities fell within this well-established rule. In the early 1960's, however, concerns were expressed that the tax deferral available to holders of nonqualified variable annuities, when coupled with the corporate-level deduction for reserve increases reflecting appreciation in variable annuity separate account assets, would afford variable annuity writers a competitive advantage.

In response, Congress enacted existing section 801(g)(6), which denies any deduction for reserve increases allocable to the appreciation in value of variable annuity separate account assets. At the same time, the statute subjects issuers of nonqualified variable annuities to tax on any asset gains realized in such separate accounts. Thus, the asset gains are fully taxed to the issuing company. */ Despite this, the purchaser of a variable

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*/ "Qualified" contracts are treated separately under section 801(g)(7). The key difference between sections 801(g)(6) and 801(g)(7) is that issuers of qualified variable annuities (governed by section 801(g)(7)) are allowed to increase the basis of the separate account assets to reflect appreciation allocable to those assets. Thus, although issuers of qualified variable annuities do not benefit from the usually permitted deductions for increases in their reserves, they are not subject to capital gains tax on the appreciation giving rise to those increased reserves.

annuity contract is not allowed to increase his "investment in the contract" to reflect these already-taxed asset gains. Consequently, the gains are taxed again to the contractholder under the general rules of section 72 of the Code.

Assuming that this double-tax treatment of nonqualified variable annuities were ever justifiable by reference to notions of competitive equality, that justification evaporated with the amendments to section 72 of the Code enacted by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). Before TEFRA, the effect of section 72 was to provide that earnings credited to a deferred annuity contract would not be taxed to the holder until conversion of the contract into a stream of annuity payments, or until the contract was surrendered (in whole or in part) for cash. Furthermore, any amount received under an annuity before annuitization was treated first as a nontaxable return of the contractholder's investment (basically, the premium paid), and thereafter as income taxable at ordinary rates. As a result, it was perceived by some that deferred annuities might be viable as an alternative to other financial investments, with the added advantage that the earnings credited to an annuity would be taxed on a deferred, rather than a current, basis. Such perceptions originally prompted Congress to penalize variable annuities implicitly through imposition of the double-tax on capital gains.

But in 1982, led by this Committee, Congress eliminated such concerns. Under section 72(e), as amended by TEFRA, partial withdrawals from an annuity are now taxed as ordinary income, to the extent the contract's cash value exceeds the contractholder's investment. More importantly, Congress imposed an explicit penalty on the "premature" surrender of an annuity. Under section 72(q), as added by TEFRA, and subject to certain exceptions, an annuity contractholder who withdraws cash from an annuity incurs a penalty equal to 5 percent of the amount included in income.

Given these amendments to section 72, variable annuities are no longer viable as alternatives to other financial investments the income from which is currently taxed. Early withdrawals are both currently taxed and explicitly penalized. These provisions render annuities attractive principally for their historical purpose: accumulating a fund to be used to provide income security during retirement. The explicit penalty of section 72(q) deprives them of any competitive edge they might have been thought to possess over investment-based products, and of their possible utility as substitutes for short-term financial investments. Thus, the continued imposition of the implicit penalty of section 801(g)(6) no longer has even a colorable justification.

There is even less reason to extend the current treatment of variable annuities to variable life insurance. Variable life has never before been denied the reserve deductions associated with appreciation of the separate account assets. The treatment proposed in section 817 can hardly be defended as necessary to eliminate any competitive edge enjoyed by variable life. In fact, were section 817 enacted as proposed, it would accomplish just the opposite, placing variable life insurance at a competitive disadvantage. Issuers of variable life would be taxed on a portion of the earnings credited under those contracts, whereas issuers of fixed-benefit life insurance products are not. There is no sound basis on which to single out variable life insurance for such disadvantageous treatment.

A more appropriate model for taxation of issuers of variable annuity and life insurance policies would be a combination of the treatment now provided by sections 801(g)(6) and 801(g)(7): denial of the otherwise allowable deduction for reserve increases attributable to appreciation in separate account assets, together with an adjustment to the basis of those assets to reflect that appreciation. Thus, while the issuer would lose an otherwise allowable deduction, it would not be penalized through subsequent capital gains taxation. We urge the Committee to alter new section 817 in this fashion.

As a final but important related point, the Stock Company Information Group endorses the proposal of the Investment Company Institute to modify Revenue Ruling 81-225, so as to permit variable contracts to be based on mutual funds that are open to direct public ownership. In light of the already extensive tightening of section 72, as well as the additional changes proposed in S. 1992, we believe that the concerns which originally motivated the issuance of that Ruling no longer prevail.

Policyholder Tax Provisions

The hearing notice also invited comment on those aspects of S. 1992 which would alter the tax treatment of life insurance policyholders. These provisions are contained in sections 221-224 of the bill.

A. Definition of "Life Insurance Contract"

Section 221 would enact, as new section 7702 of the Code, the first permanent statutory definition of the term "life insurance contract" for all purposes of the Code. This new definition would condition the availability of the tax treatment associated with "life insurance" on the provision of no more than a maximum cash value, or the payment of no more than a maximum amount of premiums, actuarially determined for each contract. If a contract failed at any time to meet the statutory rules, proposed section 7702 would treat the holder as possessing two contracts for Federal tax purposes: a contract of term life insurance, on the one hand, and a currently taxable savings account, on the other. It thus would preclude taxpayers from securing insurance tax treatment for contracts that are unduly oriented toward investment rather than protection.

In our view, proposed section 7702 takes what is really the only sound approach to distinguishing protection-oriented life insurance policies from investment contracts. The definition it embraces fairly reconciles the legitimate needs of life insurance policyholders with the equally legitimate concerns of Congress and the Treasury Department for possible tax abuse. Also of importance to the competing companies of the industry, the proposed definition would not favor one type of life insurance policy over another. It is even-handed in its treatment of policies with flexible premiums and those with fixed premiums, and of policies with variable benefits and those with fully guaranteed benefits.

This new definition is the product of some two years of effort, first within the life insurance industry and then in discussions between the Government and the industry, to fashion for the first time a comprehensive definition of "life insurance" for tax purposes that would be product-neutral and fair to taxpayers and the Government alike. It is properly modeled on the temporary, flexible-premium contract rules of section 101(f) of the Code, as adopted by this Committee in framing TEFRA. As such, it commands our full support, and we urge this Committee to adopt its structure.

Despite this, we do believe that proposed section 7702 can be improved in a few limited respects. The two items which we think it important to invite to this Committee's attention are, first, a matter of substance, and second, a matter of transition.

The substantive matter concerns the maturity date of a "life insurance contract" as defined in the bill. Proposed section 7702 would require calculation of the maximum allowable premiums or cash values (as the case may be) to be made on the assumption, among others, that the contract does not mature (or "endow") before the insured's 95th birthday. This assumption will permit the continued sale of most whole life and universal life insurance policies. Nevertheless, it will work a fundamental change in the tax treatment of plans of life insurance -- denominated "lifetime endowment" plans, and typified by the "endowment-at-age-65" and the "20-year endowment" -- that are scheduled to endow before age 95. If enacted in its proposed form, section 7702 almost surely will operate to ban such contracts from other than the tax-qualified marketplace. Any life insurance policy scheduled to pay its face amount before age 95 while the insured is living will fail to meet that statutory definition and will, under the general rule of proposed section 7702, be treated as term insurance and a currently taxable savings fund.

Understandably, proposed section 7702 must draw some lines, even some arbitrary ones, in distinguishing life insurance policies from investment arrangements. In drawing these lines, moreover, some assumption must be made about the maturity date of the contract. The progenitor of proposed section 7702, section 101(f) of the Code, employed just such an assumption. As written by this Committee, however, section 101(f) chose a somewhat more liberal formulation. In computing the premium limitation, a life insurance contract was assumed to mature at the latest date permitted under the contract, with the stipulation that this date fall at least 20 years after issue. This rule permitted a flexible premium policy to mature, for example, by the insured's 65th birthday, provided that the policy was issued before the insured reached age 45.

A useful social purpose has been, and continues to be, served by life insurance contracts that are scheduled to mature when the insured is living at age 65 or after a 20-year period. Such endowment policies provide both insurance protection before maturity, typically keyed to the insured's retirement age, and a fund to provide retirement income benefits should the maturity date be survived. Because of their substantial life insurance component, the Federal tax laws have always treated endowments as life insurance contracts until their maturity date is reached (or until the "pure" life insurance element otherwise ceases). It seems to us that this Committee, in drafting section 101(f) of the Code (albeit as a temporary measure), properly chose to treat long-term endowments in the same manner as other life insurance contracts for Federal tax purposes.

Incorporation into section 7702 of the section 101(f) approach would not disadvantage the Government. The death benefit exclusion -- the tax treatment normally applied to life insurance benefits payable on the death of the insured -- is transitory in the case of a lifetime endowment policy. It expires when the contract endows. Should this Committee decide to preserve the current treatment of long-term endowments, it would simply preserve the "trade-off" that now exists. On the one hand, in the case of a life insurance policy maturing near the end of the mortality table, the tax exemption for death benefits would be permanent. In the case of an endowment policy scheduled to mature at the insured's age 65 or 70, on the other hand, the exemption for the proceeds would disappear contemporaneously with the cessation of the protection element of the contract, leaving the policy proceeds includible in income.

We therefore urge this Committee to consider modifying the maturity date rule of proposed section 7702 so that it conforms with that of section 101(f). This will permit the continued use of lifetime endowments to fulfill their appropriate functions. We reiterate that preservation of the maturity date rule now in the bill would simply eliminate such policies from the marketplace, a development that we regard as undesirable.

Our transitional concern centers on the fact that S. 1992, in parallel with the House bill, would make the new definition of "life insurance contract" generally effective for policies issued after December 31, 1983. As detailed in proposed section 7702(i), however, certain classes of contracts issued before January 1, 1985, would be relieved of the need to comply with one or more of the new definitional rules. In addition, one class of multiple-premium contracts would be permanently exempted from certain of the new requirements.

We note that, from the standpoint of those who drafted these provisions during the summer of 1983, the new definition was written to take effect some number of months after enactment of the proposed legislation. Moreover, the statute provided an additional one-year period, beginning with its prospective effective date, during which life insurance companies would be permitted to sell technically non-conforming but "non-abusive" policies. This period would have given companies the time needed to design, file, and prepare for market new policy forms which would comply with the technical requirements of section 7702.

In these circumstances, we think it fair that a new, fully prospective effective date for proposed section 7702 be substituted for the year-end-1983 date in S. 1992. Thus, we strongly urge this Committee to make the new rules effective only for contracts issued more than one year after enactment of S. 1992. This would maintain the prospectivity that we think fairness requires, while avoiding the need to craft case-by-case exceptions to the unduly restrictive general transitional rule now contained in S. 1992. We also urge the Committee, in connection with fixing a fully prospective effective date, to extend existing section 101(f) so that it expires simultaneously with the effective date of section 7702. In 1982 this Committee wrote section 101(f) with a January 1, 1984, termination date, and an extension of this date is needed to avoid any "gap" in coverage of the various statutory provisions. */

We realize that the Treasury Department and others have expressed the view that proposed section 7702 should take effect as of January 1, 1984, admittedly with the provision of transitional relief, so as to halt the sale of non-conforming, "abusive" insurance products. Should this Committee consider certain products to be of such a nature as to warrant retroactive application of the new rules, then we suggest that such action be taken only with respect to them. We would caution, however, that there well may be a substantial element of inequity in applying the new rules retroactively even to contracts

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*/ In suggesting the substitution of a prospective effective date for the provisions currently appearing in S. 1992, we do not mean to imply any dissatisfaction with the proposal set forth in section 7702(i)(2), relating to certain multiple-premium contracts. We think it appropriate that the contracts described in section 7702(i)(2), as proposed in S. 1992, be granted the permanent relief contemplated in the bill.

considered in some quarter or another to be "abusive." It should be obvious that there is no universal definition of "abusive." We suggest that, should this Committee decide to apply the new definition to some products in advance of the general effective date, the better solution would be to apply the definition to such products as of, for example, the date of the legislation's enactment or the date that this Committee makes its decisions.

If, despite the foregoing considerations, you adhere to the 1984 effective date now in S. 1992, we think it imperative that the case-by-case exceptions to the proposed transition rule undergo a significant expansion. To the three classes of policies now covered in the transitional provisions of proposed section 7702(i), we consider it necessary, at minimum, to add the following four classes of contracts: */

- o Fixed premium life insurance policies which, although not meeting the definition of "flexible premium" contracts and therefore not technically subject to section 101(f), were voluntarily designed (or redesigned) to comply with section 101(f) in the interests of removing any doubt about their treatment under the Federal tax laws.

- o Life insurance policies, known as "irreplaceable life" policies, which provide for fixed

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*/ We also think it important that section 7702(i)(2) be clarified to remove any doubt that so-called "indeterminate premium" whole life insurance policies requiring 20 or more annual premiums fall within the definition of a "qualified 20-pay contract."

annual premiums that are to be adjusted periodically in anticipation of future interest and mortality experience, and which provide that the death benefit may be changed so as to prevent an increase in premium at the time of an adjustment.

- Endowment policies providing for maturity before age 95, if this Committee should decide not to adopt our suggestion that such policies be sanctioned by the new definition.
- Life insurance and endowment policies which would qualify under the proposed definition, as modified by the proposed transition rules, except that they contain interest guarantees at a rate of less than 3 percent.

In short, our view is that, in fairness, the new statute would require exceptions of differing sorts for at least seven classes of contracts -- and possibly for others as well. We have already furnished to the Committee's staff a description of the policies involved and our recommended statutory changes. The cumbersome nature of this approach, however, leads us back to the position that we prefer and that we hope you will adopt.

Despite these limited considerations, however, we again underscore our support for the new definition of "life insurance contract" contained in S. 1992.

B. Other Policyholder Provisions

We likewise endorse the balance of the policyholder provisions of the bill. We recognize that, in some instances, these provisions will effect significant changes in policyholder taxation, and that other witnesses at the hearings may question the desirability of one or more of those changes. For our own part, we wish to express some reservations about only two items. The first is the change in the treatment of nonqualified deferred annuities at the death of the contractholder. The second involves the sufficiency of the proposed revisions to section 264 of the Code.

As we have already pointed out, TEFRA brought about major changes in the tax treatment of nonqualified deferred annuities, changes designed to ensure that the tax deferral available to earnings under deferred annuities was limited to contracts purchased as a means of saving for retirement. That latter objective was endorsed by this Committee in its Report on the revenue provisions of TEFRA, which observed that "the use of deferred annuity contracts to meet long-term investment goals, such as income security, is still a worthy ideal." */

While the amendments in TEFRA were designed to avoid conferring tax deferral on annuities used for short-term investment, section 222(b) of S. 1992 contains yet another new rule, which appears to be motivated by a concern for the possibility that the tax deferral under some deferred annuity contracts might persist for an unduly long time.

In other areas in which Congress has conferred tax deferral on retirement savings, it has acted to foreclose unduly

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*/ S. Rep. No. 494, 97th Cong., 2nd Sess., vol. I, p. 350 (1982).

prolonged deferral. For example, the rules governing the taxation of "individual retirement accounts" (or "IRAs"), for which an individual is allowed a deduction on making contributions, require such accounts to be distributed by the time an individual attains age 70-1/2. In addition, if the account holder dies before reaching that age, and if the contract has not already been converted into a stream of retirement income payments, the account must be distributed, and taxed shortly after death, except when it passes to the owner's spouse.

We assume that section 222(b) of S. 1992 also was designed to terminate the deferral under a nonqualified deferred annuity contract on the death of the owner. It requires that, if the contract has not already been annuitized, the earnings under the contract as of the death of the holder be included in the holder's final income tax return. It thus is significantly more stringent than the corresponding IRA rule, which we find curious in view of the fact that deferred annuities are taxed substantially less favorably than IRAs. While the earnings under both kinds of contracts are deferred until liquidation of the contract, contributions to an IRA are deductible, whereas nonqualified deferred annuities must be purchased with tax-paid dollars. If any deferral termination provision is to be imposed on deferred annuities, it would be more appropriate to fashion a rule that is somewhat less stringent, rather than substantially more stringent, than the corresponding

IRA rules. In this regard, we urge you to consider all possible alternatives and adopt a rule less severe than that proposed in section 222(b).

Our second comment goes to the sufficiency of section 223 of S. 1992, which would amend section 264 of the Code to limit further the availability of deductions for interest paid on life insurance policy loans. While we do not question the details of section 223 of the bill, we think you should take advantage of this opportunity to update section 264 in light of recent developments in policy design, in particular the advent of flexible premium life insurance policies.

One of the most apparent and significant purposes underlying S. 1992 (and the companion House bill) is to secure equal tax treatment for holders and beneficiaries of competing life insurance policies. In this regard, section 264 of the Code, like proposed section 7702 and the company tax provisions, should apply without discrimination as between fixed premium and flexible premium policies. The systematic borrowing (or "minimum deposit") rules of section 264(a)(3) and (c) of the Code currently permit deductions for interest on amounts borrowed to pay for a non-single-premium life insurance policy if, among other things, four of the first seven annual premiums "due" on the policy are paid without borrowing from any source. While fixed-premium policies -- those with premiums "due" -- fall within this "safe harbor," it is not entirely clear whether flexible premium policies (such as universal life insurance) do too. Further, because of a general ruling ban in the section 264(c)(1) area, the Internal Revenue Service will not provide guidance as to the status of flexible premium policies under this provision.

We consider this discriminatory against flexible premium policies. Accordingly, we suggest that this Committee revise section 223 of the bill to amend section 264(c)(1) of the Code, deleting that provision's reference to premiums "due" and inserting in its place the term "paid". It is our belief that whatever restrictions are ultimately placed on the deductibility of interest paid on policy loans, they should apply equally to fixed and flexible premium policies.

Conclusion

In conclusion, and despite the several changes we have suggested, we wish to reiterate our support for S. 1992 as a whole. It generally will simplify and improve the taxation of life insurance companies and their policyholders, it will lend needed certainty to a variety of issues that have arisen in this area, and will raise substantial revenue from the life insurance industry. We stress once again the importance of prompt enactment of this legislation, and we pledge our full cooperation to this Committee in the interests of achieving that objective.

STOCK COMPANY INFORMATION GROUP

Aetna Life Insurance Company
Allstate Life Insurance Company
American General Life Insurance Company
Business Men's Assurance Company of America
Capital Holding Corporation
CNA Insurance
CIGNA Corporation
Federal Kemper Life Assurance Company
Franklin Life Insurance Company
Hartford Life Insurance Company
E.F. Hutton Life Insurance Company
IDS Life Insurance Company
Integon Life Insurance Corporation
Jefferson Standard Life Insurance Company
Kansas City Life Insurance Company
Liberty Life Insurance Company
Liberty National Life Insurance Company
The Life Insurance Company of Virginia
Lincoln National Life Insurance Company
Monumental Life Insurance Company
The Paul Revere Life Insurance Company
Provident Life and Accident Insurance Company
Southwestern Life Insurance Company
Transamerica Occidental Life Insurance Company
The Travelers Insurance Company
Washington National Insurance Company